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Moldova Economic Growth Analysis

Contributors:
Ana Popa, coordinator
Valeriu Prohnitchi
Alex Oprunenco
Adrian Lupusor
Elena Culiuc
Dumitru Budianschi

Expert-Grup
CENTRU ANALITIC INDEPENDENT

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Key Policy Messages

- One of our previous predictions turned true – the big number of businessmen in the Parliament would result in a competition for the redesign of the spheres of economic influence rather than in speeding up reforms to streamline the business regulatory environment and enforce competition across the economy. A particular feature of the on-going political skirmish is that the stake is not as much taking control over the private entities but rather saddling the public financial flows. Nonetheless, as side-effect of this war, the public found out how rotten are the governance mechanisms in the public economic sector;
- The on-going political infighting not only develops the weak foundations of the ruling coalition, but also disenchants the domestic public willing to see reforms rather than puppet shows. The disheartening sentiment of the 'democracy and reform fatigue' may easily undermine the success story, while the EU and US would be forced to bring the honeymoon to an end and increase pressures on the country to deliver its promises. If this requires resetting the ruling coalition, so let it be. However, a new coalition will largely operate along the same lines as the current one unless a comprehensive institutional and decision-making reform takes place in the central public administration.
- In 2010 we witnessed an impressive recovery and in 2011 an even more impressive growth. However, this growth still rests on fragile and narrow foundations both in social and geographic terms, with a somewhat eerie reflection on the labour market. The continuous political infighting lefts little time and resources for addressing key regulatory hurdles and anti-competitive arrangements that limits room for private sector growth. In these two areas, many commitments that Moldova undertook as part of the EU-Moldova Action Plan in 2005 remain constant parts of yearly action plans that the Government keeps adopting.
- A number of critical constraints are key factors behind the expected slow-down of economic growth in mid-term. Poor infrastructure, high logistical costs, red tape and underdeveloped human capital have not been tackled properly by current government and will undermine production expansion and long-term prospects for growth. The same key factors undercut the export expansion and preclude Moldova's transition to the new growth model. In the recent half year we saw few decisive actions to address the constraints in question, with many senior level public officials advancing ridiculous explanations for their failure to advance key reforms in these areas.
- Banks economic sentiments have significantly improved in the recent half year. For a government willing to change the country's economic development model, this is a good sign. While not all of the commercial banks are on sound footage again, and few hoard toxic assets, most are full of liquidity and willing to finance private sector rather than the public budget. The key challenge is to increase the access of the small companies to loans, and to address the structural and legislative issues keeping cost of loans at high level.
- While even patchy regional recovery sufficed to propel strong expansion of trade and fuelled robust GDP growth, the heightening volatility underlines Moldova's frailties and weaknesses. As commodity prices rocketed Moldova appeared largely unprepared to this development. On instances of both rising fuel and food prices Moldova found itself on the receiving end. On the energy front, uncompetitive arrangements and stagnating regulatory and energy sector reforms decimated competitiveness of domestic companies and made the households even poorer. On the food front, the Government reacted in knee-jerk protectionist fashion, while farmers and consumers alike found themselves worse off. As global economic outlook has all chances to turn grimmer, it is up to Moldova whether to adapt and capitalize on these changes or to 'enjoy' its victim status further on.

Statistical Indicators

Table 1. Moldova: key long-term economic and socio-economic indicators

	2007	2008	2009	2010	2011 forecast
Population, million (excludes Transnistria), beginning of the year	3.581	3.573	3.568	3.564	3.558
GDP, billion MDL, current prices	53.430	62.840	60.429	71.849	84.200
GDP, billion USD, current prices	4.395	6.047	5.409	5.810	7.200
GDP per capita, USD at PPP	2715	2986	2843	3088	3540
Real GDP, y-o-y % change	3.0	7.2	-6.5	6.9	6.6
GDP deflator, y-o-y % change	15.9	9.7	2.0	11.2	10.0
Private consumption, y-o-y % change	3.6	4.5	-7.9	9.0	8.0-9.0
Gross fixed capital formation, y-o-y % change	25.5	2.2	-30.9	17.2	18.0
Industrial production, y-o-y % change	-1.3	0.7	-22.2	7.0	5.0
Agricultural production, y-o-y % change	-23.1	32.1	-9.9	7.9	1.1
Share of industry in GDP, %	19.1	13.9	13.0	13.2	12.0
Share of agriculture in GDP, %	10.0	8.8	8.5	11.9	10.3
Merchandise FOB exports, million USD	1373.3	1646.0	1331.6	1541.5	1896
Merchandise CIF imports, million USD	3676.4	4866.3	3275.8	3855.3	4703.5
Service exports, million USD	625.08	837.2	668.9	689.8	n.a.
Service imports, million USD	631.2	824.7	701.8	-770.1	n.a.
Net foreign direct investment, million USD	522.0	691.5	121.1	195.4	n.a.
Net work remittances, million USD	1419.4	1795.8	1124.4	1282.4	1430.0
Current account/GDP, %	-15.2	-16.7	-8.6	-9.0	n.a.
Official reserve assets, end-year, million USD	1333.7	1672.4	1480.3	1717.7	1900.0
Total external debt stock, million USD	3345.5	4093.8	4364.1	4778.7	4820.1
External debt/GDP, %	76.3	67.9	80.8	82.2	72.4
External debt/exports of goods and services, %	167.4	164.6	215.1	310.1	n.a.
Employment rate, % of population aged above 15	42.5	42.5	40.0	38.5	40.0
Unemployment rate, % of economically active population	5.1	4.0	6.4	7.4	7.5
Real wage growth rate, y-o-y % change	8.0	10.2	9.0	0.7	4.0-5.0
Consumer prices index, year average on year average % change	12.3	12.7	0.0	7.4	8.0
General government balance, % of GDP	-0.3	-1.0	-6.8	-2.5	-2.3
General government expenditure, % of GDP	41.8	41.6	45.3	40.8	39.6
Exchange rate, year average, MDL per USD	12.1	10.4	11.1	12.4	11.7
Broad money (M2), y-o-y % change	47.3	18.3	-3.8	18.3	20.0
Central bank refinancing rate, end-year, %	16.0	14.0	5.0	7.0	8.0
Total commercial bank loans, % of GDP	37.2	37.5	35.0	32.6	35.0
Bank deposit rate, %, average per year	15.1	18.1	14.7	7.6	7.5
Bank lending rate, %, average per year	18.9	21.0	20.3	16.3	15.0

Source: NBS, IMF, NBM and Expert-Grup calculations, estimates and forecast;

Summary

Governance

The Moldovan economy continued to develop amidst the environment of the 'provisional' governance. Such a model of governance featured growing political instability and lingering constitutional crisis, acrimonious infighting in ruling coalition, protracted stalemates in reform agenda across the whole board of arduous issues, and so on. This however has not yet blemished significantly the image of the "success story" image bestowed on Moldova as the EU has maintained its apparently unconditional support and admiration towards Moldova. The realities on the ground will eventually match or collide with outside perceptions as the country enters an undoubtedly critical half of the year.

Business Climate

Winning the foreign investors' trust is the key to achieving post crisis recovery, not just for Moldova but for any country. However, given the scarcity of the funds and increasing hesitation, investment flows (particularly FDI) are getting harder and harder to lure. Under such circumstances ensuring a favourable business climate should be one of the main objectives for Moldova's government. While the authorities are clearly making attempts at improving Moldova's ranking, many of these attempts are rather superficial, or worse – ill-founded. Competition regulation, red-tape and standardisation still constitute major problems for both local and foreign entrepreneurs. In the global competitiveness ranking Moldova is still placed below the world average, although nearly all the publications under review identify positive trends.

GDP

The magnitude of economic recovery set up Moldovan GDP in 2010 at the pre-crisis level and the take-off continued in early 2011 with even more impressive advances. However, as much as the quality of growth is concerned, Moldova is getting back to the pre-crisis growth model that provides too much comfort for the Government with no pressure to act rapidly and efficiently. Thus, the strong investment growth is shadowed by the hike in consumtion in Q1'11. The growth is expected to continue against the background of economic recovery and expiring provisions of 'fiscal paradise' with zero corporate income tax for reinvested profits. Indeed, consumption-based growth is the only feasible option for Moldova in short- and mid-term, but the Government should trade on inflows of remittance for promoting private and public investments. Otherwise, in long-run Moldova will end up with rising prices rather than expanding output and employment.

Agriculture

In Q1'11 the agricultural growth was propped up by the livestock subsector. However, despite the recent growth and advantageous price trends, the domestic supply of animal products is far behind the demand. Meanwhile the prices scissors are eating away the farmers' income and putting more strain on the rural economic life. In fact, analysis of the income structure shows a growing dependency of the farms on remittances and social transfers. Arbitrary policy decisions – such as sudden ban on exports of wheat on 'food security' grounds, 'convincing' the sugar producers to halt sugar exports, or administratively repressing the growth of bread prices – do not make life easier for farmers. Aside from refraining to adopt such decisions, the Government has to put more emphasis on promoting round-the-year agricultural activity, adopting farmers' training as direction for agricultural subsidies and facilitating the marketing efforts.

Industry

The recent growth in industry is spectacular in annual comparison, but modest considering the sectors' need to recover to the 2005's pre-crisis level. Mining industry enjoys a strong recovery, but its short-term perspectives depend on the recovery in the constructions sector, which so far remains feeble. The manufacturing sector is on the bright side as well, but risks are flying high, especially in such sectors as vegetables and fruits processing industry, meat processing, dairy products and tobacco processing. The picture is even less rosy considering the fact that these sectors represent the backbone of industry at the regional level. Considering the regional profile of industrial growth in 2010, several districts require immediate assistance for the development of the industrial development plans. Another priority is the development of management performance criteria for the state-owned enterprises.

Constructions

The constructions sector is slowly recovering its positions. However, the revival is far from homogeneous: the figures for Q1'11 prove that companies are willing to invest in machinery, equipment and transportation vehicles, yet remain reluctant to invest in real estate. The investments in residential buildings are also lagging behind the last year figures. Entrepreneurs in that field seem reluctant to launch new projects before the available apartments are sold out. In the meantime clients are patiently waiting for the prices on the real estate market to go down. The private banks are offering some 'wicked' mortgage rates that just flatter to deceive.

Services

The service sector enjoyed an overall growth that was fuelled by the increased internal demand. Although all the subsectors grew, the magnitude varied widely from one sector to another. While, the retail trade and sales of personal goods were clearly booming, the telecommunications sector increased only slightly in yearly comparison. In addition, both the transport of passengers and transport of goods had remarkable growth patterns. The performance of the hotel service sector was also very promising, especially considering that in 2010 this sector hit the 7-year lows.

Labour Market

With one year delay, activity and employment rates reacted to the economic recovery. However, the overall situation on the labour market is still poor, with continuously declining employment in agricultural sector. This trend will continue since the sector is poorly technically-endowed, unable to provide decent incomes and often exposed to internal and external shocks. Meanwhile, employment in service sector is the main determinant of the improvements on the labour market, fully reflecting the sources of the economic growth in the post-crisis period. Still rising unemployment persist as a post-crisis effect, this way Moldovan labour market converging to a theoretical model featuring both low employment rate and high unemployment rate; though a stabilization of unemployment rate is expected by the end of the year. This may ease the pressures on the State Social Insurance Budget that had to deal with increasing demand for unemployment benefits, so that the Government was bound to revise its social benefits policy.

Households

In late 2010 and early 2011 wages increased in almost all economic activities, with no major influence on the wage gap between sectors. At the same time, in the budgetary sector a wage rise was set for teachers, while in health system no major changes were planned despite still lower-than-average per economy wages. In mid-term, setting competitive salaries in public sectors is essential to ensure the quality of public services and eliminate corruption. Consumption also hiked in this period partly due to wage rise, expansion of consumer credit and, routinely, due to higher inflow of remittances. Most probably, the trend will persist throughout this year, however, as the stock of potential migrants is declining, we do not expect similar growth rates of remittances starting with 2012.

Prices

At the end of Q2'11, the annual CPI exceeded the National Bank of Moldova (NBM) target with the utilities sector appearing the chief culprit. It was due to a mix of strong cost-push factors and mounting monetary inflationary pressures. The spike in fuel prices and in other imported inputs inflated production costs and made the domestic prices to adjust. The demand-side inflationary pressures are determined by the fully-fledged credit expansion and recovering remittances which gave a fillip to domestic consumption. Besides the welfare costs, in the medium and long-term inflation creates significant economic distortions. We expect this inflationary overshooting to persist until the end-2011, while in 2012 it is likely to fit into the central bank's target, as the cost-push factors will subside.

Monetary Policy

Given the mounting inflationary pressures and the second round effects of energy and foodstuffs inflation, the central bank started winding down its monetary accommodative policy. Due to slow transmission channels, it resorted more actively to its requirement reserves ratio. Despite these tightening steps, the monetary policy remained relatively lax in comparison with the pre-crisis period, revealing the central bank desire to walk a tightrope between steering inflation to the targeted level and avoiding perils to the economic take-off. The central bank tried to implement an authentic free-floating foreign exchange regime, as it drastically reduced its interventions on the domestic FOREX market which spurred the exchange rate volatility. Given the robust economic recovery and ample credit expansion, central bank could continue gradually tightening its monetary policy, in compliance with its inflation targeting strategy.

Budgetary Policy

The growth in the National Public Budget revenues as a result of the economic growth and the expenditure adjustments in 2010 led to a lower than planned deficit last year. This year also looks promising in this respect. In the first half of 2011 a slight change on the expenditures side was observed with more emphasis put on the development of the public and economic sectors, while the structure of the revenues remained unchanged. The over-sized public sector and the structure of the revenues, with an excessive weight of the indirect taxes, still remain the main threats to the financial stability. Therefore a more active implementation of the optimization reform in the public sector as well as more sustainable structure of the budgetary revenues is absolutely necessary.

Financial Sector

The economic recovery made the commercial banks to switch from crediting the Government to the real sector. This trend was fuelled by decreasing cost of credit, due to lower risk premiums applied by commercial banks. As a result, the overall financial situation in the banking sector significantly improved: efficiency, quality of banks' portfolios and profitability increased. At the same time, the sector remains far from its pre-crisis level, as some banks still encounter difficulties in cleaning up their balance-sheets. The insurance sector enjoyed a nascent recovery driven by the sales of mandatory and quasi-mandatory insurance products for cars and car drivers. It was directly determined by the moderate growth on the cars market, while the demand for non-mandatory insurance remained low, revealing the limited confidence in this sector. The lending interest rates are likely to remain at the current historical lows, while the situation in the banking and insurance sectors will continue gradually improving.

Foreign Trade

The recovery of foreign trade not only continued but also became firmer in the first half of 2011 as both exports and imports expanded at breath-taking speed. Exports' growth is continuously driven by recovery dynamics but also by some tentative structural changes epitomized by growth in non-traditional sectors. Imports were routinely driven by rebounding remittances, recovery of traditional and nascent chain productions as well as rising prices for fuel. Although exports expanded faster than imports the macro-level picture looked increasingly familiar. Rising trade deficit, as well as worsening ratio of the current account deficit to GDP showed underlying weaknesses in economic development of the country: growth based on consumption, low level of domestic production and competitiveness. This trend reflects limited success and pains of transition to a new economic growth model for which Moldovan government has craved.

Global Economy and Markets

The global economic growth has continued to show the already familiar trends: generally stagnant advanced world and buoyant emerging economies. As global imbalances remain very much unresolved and majority of developed countries faced significant budget constraints, the economic centre of gravity continued moving towards emerging markets. So while the world economy expanded by 4.3%, y-o-y, in the Q1'11, this healthy growth should not hide growing discrepancies between stagnant and debt-laden most of advanced world and dynamic but excessively dependent on external demand emerging world. The situation on the commodity markets remained highly volatile. The Q1'11 featured rising prices almost across the whole board of commodities. The trends had daunting impacts over Moldova, as rising fuel prices hit both companies and consumers. At the same time, although Moldovan consumers feel the rise of food prices, it appeared that Moldovan farmers had not been able to capitalize on this trend properly.

1. Economic Governance

A difficult task of reforming: a labour of Sisyphus?

Domestic environment: of masters and puppets...

No one expected this year to be an easy walk for the re-established ruling coalition. The knotty negotiations which required outside intervention to succeed highlighted the possible hurdles, but as it often happens, reality proved to be even more convoluted. Obviously, parties comprising the ruling coalition have different backgrounds, business interests, geopolitical leanings, categories of voters, etc. Furthermore, the first half of 2011 showed that members of AEI II coalition learnt little from AEI I experience as normal communication between them has not been ensured, the distribution of roles has not been either established or respected, etc. Last but not least, they view the reform agenda differently.

In fact, it appears that among all differences the one related to business interests has become a key and dividing trait. On several major issues, such as justice reform, public budget, services liberalization, the conflicting business interests have transpired and have brought almost any reform effort to a halt. As in any captured state[1], these vested interests permeated public administration system, including ministries and other national public bodies (staffed along party lines and not according to meritocratic principles mandatory for civil service). Since different components of the ruling coalition bow to different vested interests, any comprehensive and meaningful reform has become virtually impossible while lack of proper provisions on dispute settling has allowed any part of coalition obstruct and abort it. In a way, reform process has become hostage of ambitions of conflicting interest groups. Moreover, as public agencies become undermined by vested interests, institutions cease functioning properly and become unresponsive to legitimate demands of the citizenry. By the same token, political elites unable to break this deadlock appear to be self-serving. If story continues repeating, public becomes disenchanted and disengaged, support for comprehensive reforms fades away and chances for modernization become slim. In its turn, even when the Government attempts to solve a problem it cannot rely on viable institutions and market mechanisms since their logic is determined by vested interests and not by laws or public interest. Hence, growing penchant for dirigisme as occurred in the case of market of medicines, ban on wheat exports or plans to create an agri-food mammoth marketplace.

Vested interests need to straddle public financial flows in order to thrive. As public sector remains largely unreformed, public enterprises along with various public funds serve as wells from which vested interests drain financial liquors. On several occasions we warned that massive presence of businessmen on the party lists risked heralding future war between incumbent and contending interests. The worst scenario, 'mortal combat', foresees the infighting until knock-out of one of the coalition 'partners'. From this perspective, the current infighting is nothing else than fight to control the public financial flows between the incumbents (those who have inherited their control since times of previous rule) and contenders (those who have come to challenge former order). At the same time, the struggle for the control over public flows could serve as a proxy for

[1] See Joel Hellmann and Mark Shankerman, *"Intervention, Corruption and Capture: the nexus between enterprises and the state"*, EBRD, October 2000; Joel Hellmann and Daniel Kaufmann, *"Confronting the Challenge of State Capture in Transition Economies"*, World Bank, 2001.

eventual contest over the private assets. A somewhat more sanguine 'realist' hypothesis would treat the current situation as a more complex one: contenders do challenge the incumbents; however, there are benign and malign contenders. The former aspire for fully-fledged support from the West aiming at more just redistribution of economic leverages to unlock the reforms, while the latter seek to oust incumbents only to take their place.

External environment: keeping the dream alive...

Amidst such a protracted stalemate the external drivers for reforms become of key importance. The external environment has so far been extremely favourable and has helped keeping Moldova's European dream alive. In fact, it is even slightly counterintuitive that Western support has been maintained against a backdrop of stalling reforms and political instability. Clearly, deftness of Moldovan diplomacy played a huge role. But even more so did the overall geopolitical environment on the eastern wedges of the EU. As democratic achievements of colour revolutions in Ukraine and Georgia backtracked, detente with Belarus president fell through; Moldova has remained a bright democratic spot in Eastern Europe[1]. Furthermore, as Russian resurgence in former Soviet Union continues, the EU and the US need to keep "Western dream of modernization" alive for nations of Eastern Europe and the Caucasus. Although Moldova's democratic progress has been somewhat overshadowed by the Arab Spring, the clout of the EU members (supported by the US) interested more in Eastern rather than Southern neighbourhood is strong enough to ensure continuous western support for Moldova. The new EC Communication on Neighbourhood Policy[2] clearly envisages more complex and more favourable framework for cooperation with Eastern partners. Moldova has also been favoured by the fact that Hungary and Poland hold the EU Presidency in 2011. Furthermore, Radek Sikorski, Polish Foreign Affairs Minister, declared that clinching Association Agreements for Ukraine and Moldova would be top priority of Polish presidency in the second half of 2011[3]. This declaration means not only that Moldova will benefit from Western support in the second half of 2011, but also that Western pressure on the country to deliver will increase. However, in order to be able to deliver the current model of governance should be changed and institutional and coalition arrangements should be reset.

Forecast

- The domestic environment will remain turbulent as the country will seek to enforce the reform agenda amidst the fight against and between the vested interests. After the coalition managed to avoid macro-economic disaster and to oversee the fragile[4] recovery, the order is now much taller. The transition to new model of growth will need to have a comprehensive institutional reform at its heart;
- This institutional reform will require putting vested interests on the leash to unlock the entrepreneurship potential to fuel economic growth in real sector. This, however, is not an easy task as vested interests' resistance will widen the gaps between different parts of the ruling coalition. Hence, political instability will linger on throughout all the period while risks of coalition and government reshuffle will heighten;
- The public enterprises and funds will be on the frontline of the clash. This eventually will shed more light of their modus operandi and could help forge public support for the overhaul of the system;

[1] See in more detail, Alex Oprunenco, *"EU-Moldova DCFTA: a springboard to modernization or a road to ruin"*, May 4, 2011.

[2] *"A new response to changing neighbourhood"*, COM (2011) 303, European Commission and High Representative of the EU for Foreign Affairs and Security Policy.

[3] http://euobserver.com/9/32580/?rk=1

[4] In sense of its foundations and not of numerical magnitude.

- The external environment will remain favourable with Western assistance and pressure maintained as Polish presidency will seek to ensure that Eastern neighbours (Ukraine and Moldova) itch closer to Association status. No doubt, this support will last until there is any hope the reforms might succeed in due time. The justice reform and settlement of the "presidential conundrum" will be of critical importance in this context.

Policy recommendations

- The second half of 2011 will be critical for Moldova's plans of European integration. The actions needed to kick-start negotiations on the DCFTA and speed up implementation of actions needed for visa liberalisation agreement should be approached with utmost seriousness and urgency. With no delay the drawbacks that have plagued Moldova's euro-integration efforts should be assessed and eliminated;
- Besides vested interests, the low competence level of bureaucracy, limited financial, human and technical resources, lack of proper inter-institutional coordination will impede the progress in the implementation of the assumed commitments. The Moldovan government will need to have a clear understanding of these hurdles and targeted assistance from international community to overcome them. Specifically, in the case of vested interests some diplomatic pressure will be required to diminish political support vested interests have in certain quarters of the ruling coalition. Furthermore, fight against vested interest should not obscure the fact that certain micro reforms can and should be done even under current circumstances;
- The public communication mechanisms should be improved. The costs and risks that will unavoidably stem from implementation of certain reforms (including DCFTA) should be communicated properly to the business community and general public, while gains and benefits should be better publicized. In a way, pro-reformist camp should create a wide-spread and informed public support for the needed reforms. By the same token, efforts to diminish adverse impacts and protect legitimate national interest should be designed;
- Consensus-seeking and piece-meal approaches will be needed to overcome political deadlock and to undo the web of vested interests. The wholesale constitutional reform aimed at strengthening presidential institution may appear a low hanging fruit solution for some but it is laden with huge risks for the democratic future of Moldova.

2. Business Climate

Looking for investment? Address the business climate drawbacks.

The post crisis period is a time when the investors are trying harder than ever to avoid risks. For that particular reason, the decision to settle for a certain economy is often conditioned by the quality of its business climate. Generally speaking, the most disadvantaged countries in that regard are those that have a higher degree of political instability, more pervasive red-tape, fewer tax incentives and a weaker infrastructure. The easiest way to check the efficiency of government's performance in improving business climate is to compare the aspired goals with the final results. Further in this chapter we will identify the extent to which the government has fulfilled its plans for improving the business climate.

Back in October 2009 the Ministry of Economy drafted the first Plan for removing the constraints affecting the business climate[1]. The purpose of the plan was to identify specific problems, offer solutions and set clear deadlines for all the government institutions involved. The most important objectives set by the plan for 2010 were: to ensure a simplified start-up's registration; to speed up the issuance of construction permits; to eliminate the licensing requirements applied to a list of restricted activities; to diminish the authorisation fees applied for the international auto-transport of goods. By the end of 2010, the plan was updated and taken further to 2011. Following the schedule of the plan, during the first two quarters of 2011 the government undertook a series of steps that would improve Moldova's business climate further on. We will present a brief outline of the most important measures taken so far.

Red-tape has always been a major issue in Moldova. Both foreign investors and local entrepreneurs report that administrative burden is still very high and constitute a major impediment for running their businesses. In fact, according to a survey conducted by the World Economic Forum in 2010, local entrepreneurs consider bureaucracy to be the third major factor that brings havoc to the efficient business administration (following policy instability and poor access to financing)[2]. Looking for a way to alleviate the situation the Ministry of Economy decided to get rid of 135 of those 406 permits and business related certificates currently issued by different state bodies. The reason behind such decision is that these permits often have overlapping functions or worse, no purpose altogether. However, the main problem behind these permits is the lack of legal backup. This aspect implies that there is no official source stating the price of the permit (if any), the documents necessary for obtaining the permits and the authority responsible for its issuance. In order to solve that particular problem the Ministry of Economy plans to create a nomenclature for all the selected permits that will remain in force. In addition, the entrepreneurs will be provided with several "one stop shops" in charge with the issuance of these permits, an initiative that will undoubtedly diminish the waiting time. All these actions are planned for the 3rd and 4th quarters of 2011 and so far they have had no impact on the business climate. However, during the first two quarters the Ministry of Economy actively sought support and suggestions from the business sector representatives.

Although ensuring a fair play on the market is not among the objectives listed in the mentioned Plan it's nevertheless an essential element of a favourable business climate. In that regard the

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[1] http://www.mec.gov.md/node/1744.

[2] The global competitiveness report 2010-2011; http://www.weforum.org/reports/global-competitiveness-report-2010-2011-0.

increased activity of the National Agency for the Protection of Competition (NAPC) is more than welcome. Since the beginning of the year NAPC has publicized few "loud" cases of unfair competition. One of these cases regarded a cartel agreement involving 7 leading fuel retailers who were ultimately charged MDL 2 million. This ridiculous fine (that was shared among the retailers) was supposedly designed to prevent further practices of that kind. Ever since that incident occurred (i.e. February 2011) the fuel prices on the world markets experienced several disturbances, yet those charged in Moldova have been constantly moving one way – up. Under such circumstances the efficiency of the NAPC's measures becomes highly questionable. However the most worrying aspect of Moldova's fuel market is the concerted hike of prices among retailers. The fact that prices are virtually identical among leading suppliers and follow the same growth patterns seems to be something more than a simple coincidence.

The overall condition of the business climate translates into the latest rankings performed by global institutions specialized in the field. The importance of these rankings should not be underestimated since they usually serve as high quality investment guides to the interested parties. Further we will present Moldova's position in several international rankings. A reputable index for estimating a country's competitiveness is Index of Economic Freedom (IEF). According to the 2011 ranking Moldova is placed on the 120th line with a general index of 55.7[1]. The current index is two points higher than the one assigned in 2010[2]. This positive evolution is attributed to the recent tax reforms and regulatory transparency. Nevertheless, Moldova ranks 40th among 43 countries in the Europe region, thus its overall score is still below the regional and world averages. According to the Heritage Foundation the areas for improvement remain the business climate and the macroeconomic management.

The Work Bank also draws up an annual ranking of business conditions – Doing Business rating. According to the most recent publication (June 2011)[3] Moldova has significantly improved some key aspects that concern the business climate. The waiting time necessary for registering property has also decreased from 48 days in 2008 to only 5 days on 2011. Another good news is that the overall time necessary for business start-up registration certificate was slashed from 15 days to just one day in 2011. Unfortunately this improvement is still questionable, since entrepreneurs are still required to submit a long list of registration documents right after the certificate is granted. To summarise, the business registration procedure has to go hand in hand with other related procedures in order achieve maximum efficiency.

Although the international rankings show some improvement, it is not all peaches and cream. In fact looking at the Plan for removing the constraints affecting the business climate for 2011 and the one drafted for 2010 it becomes quite obvious that the state bodies have not manage to implement all the intended measures which migrate from one annual action plan to another. More specifically such problems as: excessive state controls (that usually come out of the bloom); lack of regulations that concern the commercial secret; international transportation quotas - have all been taken over into the new plan 2011 simply because they were not fulfilled during the previous year. The main reason behind the delayed implementation of the objectives is the troubled interaction between the Ministries and Agencies that seem reluctant to cooperate efficiently.

Forecast

- The fact that many key measures planned to be implemented are postponed is a particular aspect proving that, in such troubled times Moldova's government is way too concerned with political infighting to have any diligence left for ensuring a competitive

[1] 2011 Index of Economic Freedom, http://www.heritage.org/Index/pdf/2011/Index2011_Full.pdf

[2] 2010 Index o Economic Freedom, http://www.heritage.org/Index/pdf/2011/Index2011_Full.pdf

[3] Doing Business in South and East Europe, http://www.doingbusiness.org/Reports/Subnational-Reports/South-East-Europe

business climate. In fact, the constant political tension is one of the obstacles that preclude the implementation of a coherent policy focused on the quality of the business climate. We do not expect significant progresses in regulatory reforms in the remainder of 2011 unless the parts of the ruling coalition come to an understanding regarding the way they cooperate and communicate with each other. Another key ingredient of success is the political nominees gathering immunity in the face of vested interests permeating the state institutions they are appointed to run.

- It is no secret that the competition law currently in force was approved back in 2000 and is no longer pertinent for handling such issues as monopoly markets and cartel agreements. A new law that provides basis for settling such issues has already been drafted by NAPC and has been made public. The agency intends to further improve the current draft with the aid of European experts. It is envisaged that the final draft of the law will approved by the end of the year. However, considering the sensitive issues targeted by this law, it is very likely that vested interests will try to slow down the approval, or worse to alter the content of this law.

Policy recommendations

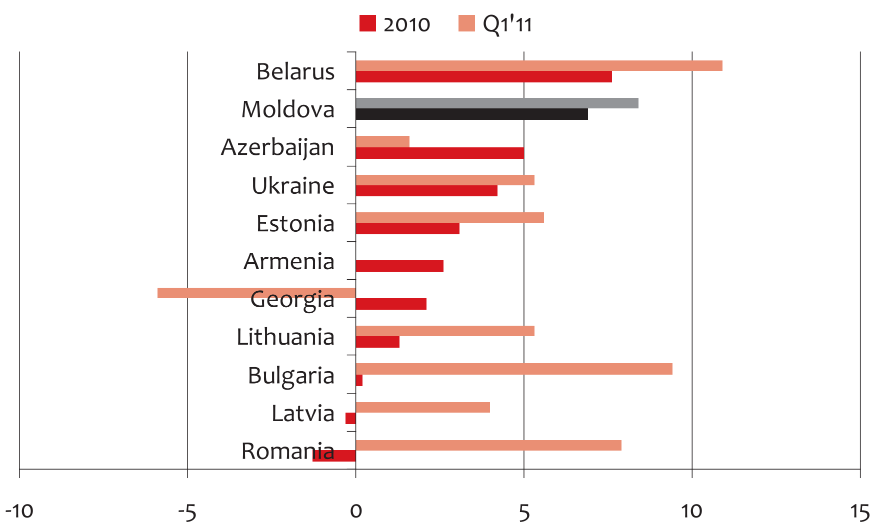
- The fuel prices in Moldova are not only a remarkable case of institutional inefficiency (as presented in the "Evolutions" section of the current chapter) but also an important input resource that might significantly influence the ultimate price of both goods and services. Should the authorities remain "deaf and blind" to this situation, the high fuel prices might translate into even higher production costs (that ultimately play a key role in attracting FDI). While this issue if far too complex to be solved in the short run the authorities should definitely work on a set of mechanisms that allow the prevention of cartel agreements such as the one identified by NAPC in Q1'11.

3. Gross Domestic Product

Outstanding growth: how long will it last?

The magnitude of Moldova's economic recovery in the aftermath of the global economic crisis is truly impressive. With a 6.9% rise in GDP in 2010, Moldova returned to its pre-crisis GDP level and did relatively well compared to other countries in the region. Early 2011 data turned out even a bigger surprise. The 8.4% GDP growth in Q1'11 beat even the most optimistic expectations as the Government revised its forecast upwards by 0.5 p.p. to 5% in May 2011. Moldova's performance is outstanding by regional comparisons as well (Chart 1).

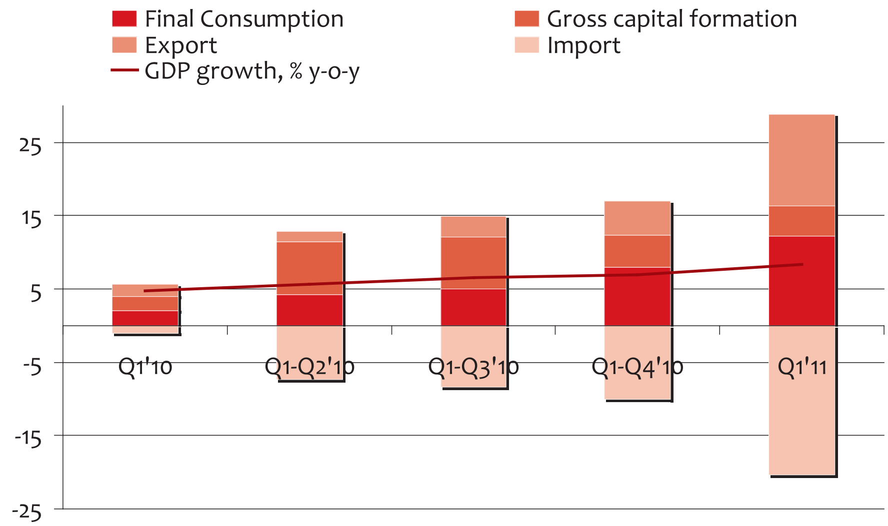
Chart 1. **GDP growth, y-o-y, % change, 2010-2011**



Source: NBS, CIS Statistics, Eurostat;

Routinely, final consumption remained the main engine of the economic growth. With 11.9% increase in final consumption in Q1'11 Moldova is returning to its top position from the standpoint of the share of private consumption in GDP. Thus, the perception that 2010 growth was of higher quality due to stronger contribution of gross capital formation was just a nuisance as rise in investment was overshadowed by the jump in consumption (Chart 2). However, growth in capital formation is still impressive and should not be disregarded. Both investment in fixed capital and inventories reveal the optimism of the private sector. Firstly, the investment in machinery and equipment increased the most, indicating the need for more production assets and expansion of businesses. Secondly, the increase in inventories also denotes the positive expectations of companies regarding future sales. However, it should not cause an over-doze of delight as the situation is determined by overall recovery rather than by any fundamental improvement in business climate. FDI expanded only by 50% in 2010 from a very low base (and represented 3.4% of GDP) and by 73% in Q1'11. This increase was chiefly propped up by reinvested profits that rose 6 times, while the change in social capital was modest - around 33%. It is possible that foreign investors follow the same logic as the national companies and plan to extend their activity in the process of economic recovery, or they can leverage on the last year of "fiscal paradise" with zero CIT for reinvested profits. Meanwhile, investments in fixed capital financed from external sources declined.

Chart 2. Contribution of expenditure elements to GDP growth, percentage points, 2010-2011



Source: NBS;

The increase in consumption is reflected fairly enough in Moldovan external trade, as consumption was largely covered by imported goods. Although imports expanded at slower rate than exports in Q1'11, the magnitude of trade deficit determined the increasingly negative contribution of net exports to GDP (-8% in Q1'11 compared to -5.4% in 2010). Of course, high consumption modelled the structure of GDP by production elements. The share of GVA in GDP went down from 84.1% in Q1'10 to 82.9% in Q1'11, being suppressed by 17.9% rise in taxes on goods. In the beginning of the previous decade the share of GVA in GDP was about 87-88% with the lowest level just before the economic crisis (82.3% in 2008). The situation has changed slightly during the crisis, but it returned to its initial, low quality, trend rather fast. Meanwhile, although all economic sectors posted growth this was not enough to retain their weight in GDP. Only expansion in industrial sector and retail trade sufficed to avoid decrease of their share in GDP (see more in Chapters 4-7).

The main problem of a consumption-driven and remittance-based growth is that it is accompanied by high inflation. Moldova is not the only country that went through such evolutions, and other countries' experience shows that in long-term this growth is unsustainable. Continuously rising aggregate demand leads to acceleration of inflation when resources become scarce and in short-term this determines inelastic aggregate supply that consequently worsens the trade-off between growth and inflation. Thus, an increase in aggregate demand causes higher prices rather than expansion in output and employment. And this is definitely the case of Moldova. The non-inflationary growth can be achieved if an economy is able to raise potential output by improving its supply-side performance: sustained productivity gains, technology expansion of the stock of capital goods (via higher investment) and increase in the available labour supply.

Forecast

- As 2011 is poised to be still a recovery year, both investment and consumption will continue to rise, however, at different rates. The gains in consumption are set to be higher due to rise in wages, consumer credit and certainly remittances. In short- and mid-run the consumption-based growth model is on cards for Moldova; however, the evolution of the economy in long-run strongly depends on the orientation of governmental policies. Based on these assumptions, we forecast an economic growth up to 6.6% in 2011 and further slow-down in 2012 to 4.5%.

Policy recommendations

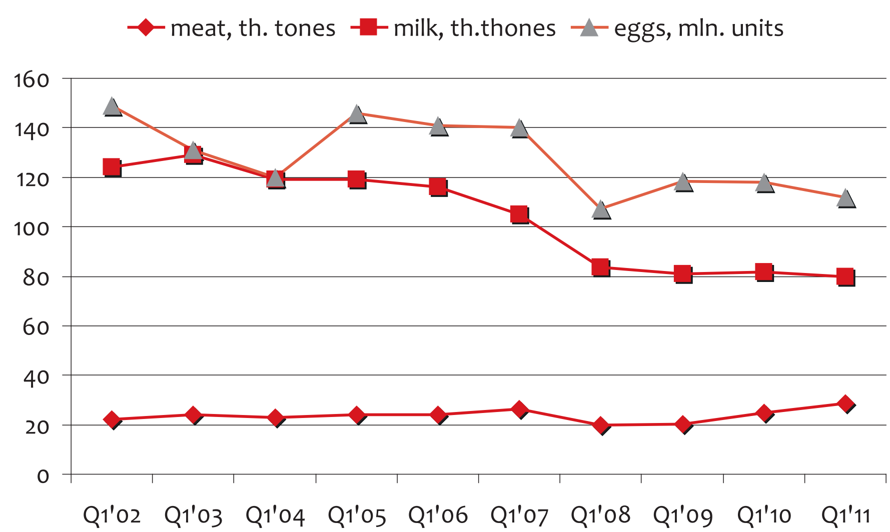
- Since 2000 national authorities, experts and international organizations have found it difficult to predict the magnitude of economic growth in Moldova mainly due to high reliance on remittances that are out of Government's control and cumbersome to forecast. These inflows account for a major part of GDP growth, therefore, even small variations may cause significant sways in GDP growth. The Government should use more comprehensive forecasting methods that keep track of regional and European economic changes in order to ensure the transition to the new economic model, based on real capacity of the economy to finance and promote investments and to reorganize adverse sectors. These models may be developed in collaboration with other existing research institutions;
- Pre-crisis growth model based on consumption is the only feasible in short- and mid-term for Moldova. Currently, it gives Moldovan authorities excessive comfort by eliminating the pressures on the labour market and pressures in formation of budgetary revenues, collected mainly from indirect taxes. However, this cannot last forever and as mentioned above, increase in consumption with no sufficient rise in output will lead in long-term to high inflation rather that gains in output and productivity. Thus, the Government should take advantage of incoming remittances and support both public and private investment. Investments in infrastructure and improvement of business climate point to the path towards the investment-driven growth;
- The transition to a competitive, innovative and investment-based economy cannot take place without qualified, high-skilled human capital. Therefore, investment in education and R&D systems is crucial. Currently, both systems do not match and do not contribute to the modernization of the economy; the quality of education is decreasing, while investments in R&D do not have the expected returns. Although difficult and with no immediate impact the reorganization of the system is necessary. This process will require higher involvement of private sector as well in educational and R&D systems. The technological transfer should be centrepiece of reform; it should enjoy a higher share in total R&D expenditures leading to positive outcomes in short- and mid-term and enhanced competitiveness of national producers on foreign markets.

4. Agriculture

High growth, small income

The 8.3% y-o-y growth of the agricultural output in Q1'11 was mainly propped by advances in the livestock subsector (+8.4%). Crops' production declined three-fold, with an overall negligible share in output (0.3%)[1]. Looking deeper into the data, it appears that growth was mainly the outcome of the poultry and cattle sold for meat production (+15.3%), whereas production of milk declined by 2% and of eggs by 5%. These evolutions pale in historical comparison (Chart 3). The picture is even less rosy considering the steadily growing domestic demand for foodstuffs unmatched by the domestic production.

Chart 3. **Evolution of the main outputs of animal origin in first quarters, 2002-2011**



Source: NBS;

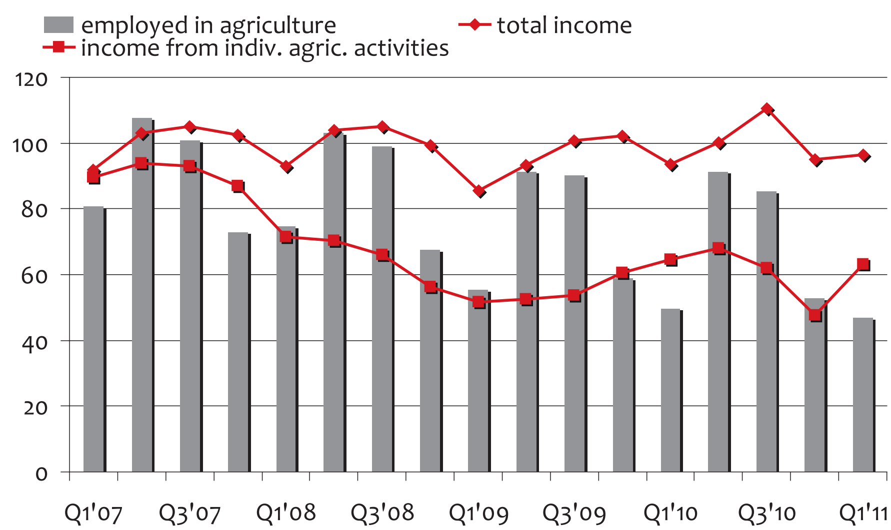
Dynamics of farm-gate prices and output moved in opposite directions: the price for meat was 11% lower than in Q1'10, whereas the prices for milk and eggs were 19.3% and 3% higher accordingly[2]. So, in terms of global income the producers of milk are better off. Nevertheless, higher global income does not necessarily mean higher profits in farmers' pockets: in Q1'11 the weighted average farm-gate price increased 17.3% y-o-y, whereas costs of some of the critical agricultural inputs increased equally fast if not even faster. For instance, in March 2011 the fuel price was 17.4% higher y-o-y, gas tariff - 31%, cargo transport – 10%. The 'price scissors' explains why positive growth of the output associates with a 1.5% y-o-y decrease in real income from individual agricultural activity

[1] NBS, "Global agricultural production in January-March 2011", http://www.statistica.md/newsview.php?l=ro&idc=168&id=3380.

[2] NBS, "Quarterly indexes of the prices for agricultural products sold by households and farms", http://www.statistica.md/public/files/serii_de_timp/preturi/preturi_agricultura/1_ind_trim_pret_agric.xls.

reported by rural households[1]. Declining income from agricultural activities was mirrored by a dramatic - 5.6% y-o-y - contraction in labour employed in this sector, including an 18% contraction in the number of employed in households-related agriculture. At the same time, the total income of the rural households reportedly increased by about 3% y-o-y in real terms (Chart 4). From a development perspective, these figures might testify diversification of the rural economic base, with the share of wages going up, while that of income from individual agricultural activities moving downwards. The 'development' argument would hold only by overlooking the growing shares of social transfers and other transfers in total income (Chart 5). In fact, since the total real income of rural households remained constant in long-term (Chart 4, the uppermost line), what we see is a growing reliance of the villagers on the transfers from the government and labour migrants rather than a true diversification of the rural economic life.

Chart 4. Evolution of employment in agriculture, total income and income from individual agricultural activities of the rural households, Q1'07-Q1'11, 2006=100%



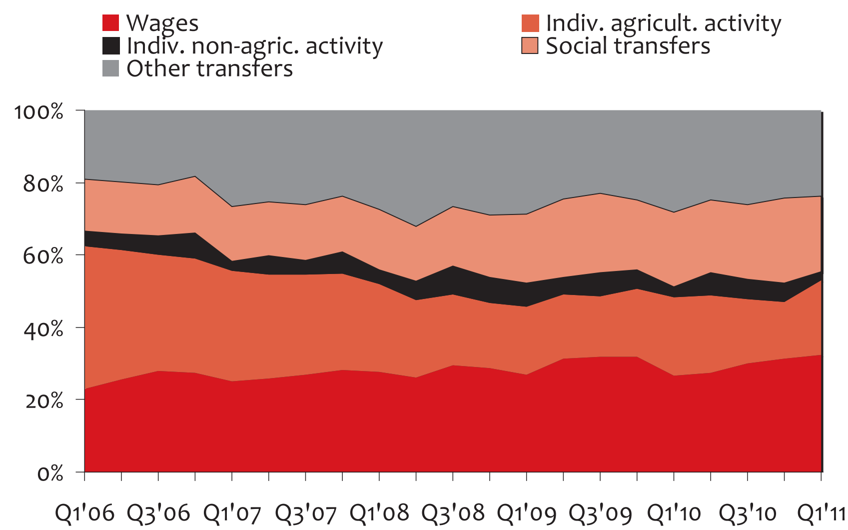
Source: NBS and Expert-Grup calculations;

On this backdrop, a number of policy decisions have caught our attention in Q1-Q2'11. One of the most contentious was ban on exports of cereals on 'food security' grounds. This decision appears rather as a desperate attempt to make private companies shoulder responsibility for government's failure to timely replenish the state reserves[2]. The series of contentions decisions does not stop here: we have seen replays of familiar patterns in the way the Ministry of Agriculture and Food Industry (MAFI) 'convinced' the sugar producers to halt sugar exports[3], or in the way it reacted to the growth of bread prices[4]. Among the inspired decisions, it is worth mentioning that MAFI and several associations of the winemaking companies signed a Wine Promotion Memorandum by which a public-private promotion agency will be created to support exploration of new markets for Moldovan wines (considering the marketing activities in recent months, China and US look as being among the most promising markets). Elaboration of the Concept

[1] NBS, "Population's income and expenditures in quarter one 2011", http://www.statistica.md/newsview.php?l=ro&idc=168&id=3440&parent=0.
[2] Expert-Grup, "Real Economy", no.17, March 2011, http://www.expert-grup.org/index.php?go=biblioteca&n=184.
[3] Ministry of Agriculture and Food Industry, "The sugar will not get more expensive", http://maia.gov.md/libview.php?l=ro&idc=52&id=14222.
[4] Ministry of Agriculture and Food Industry, "The bread price increase", http://maia.gov.md/libview.php?l=ro&idc=52&id=14414.

Strategy on foodstuff safety is another key positive development. Once the strategy is adopted by the Government, its implementation will have long-ranging implications for Moldovan exports to the EU.

Chart 5. **Structure of income of the rural households by sources of income, % of total, Q1'06-Q1'11**



Source: NBS and Expert-Grup calculations;

Forecast

- Statistical data for the second quarter were not released at the moment of drafting this publication. Heavy rain and hails in June seem to have had only a marginal impact (we estimate that around 0.5% of the harvest was destroyed). However, the mid-term impact may be more substantial because of the plant-diseases that the rainy weather may trigger;
- We expect the high prices to persist in 2011, while production costs expanding at the same pace will result in steep fall in profits across the sector;
- Annual vegetables output is expected to decline significantly, by around 15-20%. Harvest of cereals, grapes and fruits is expected to reach the levels of 2010. All in all, we maintain our previous forecast of 4% decline in crops output for 2010;
- The opposing trends in the livestock sector in Q1'11 will level off towards the end of the year and we predict an increase in annual production of 10.1%, mainly on the account of meat and eggs production. This forecast is 3 p.p. lower than the previous one (MEGA 3). As net outcome, we expect the agricultural sector to put a rather feeble 1.1% growth in 2011.

Policy recommendations

- Moldovan policymakers see the modest production of crops in the first quarter of every year as something 'normal'; in fact, it is abnormal as long as the country meets necessary climate and soil conditions for growing crops all year round in greenhouses, tunnels, etc. With food prices growing globally, not making full use of agricultural potential is a suboptimal economic strategy and a key reason of the Moldova's underdevelopment. Promoting round-the-year agricultural activity should be one of the key priorities of the Moldovan agricultural policy;

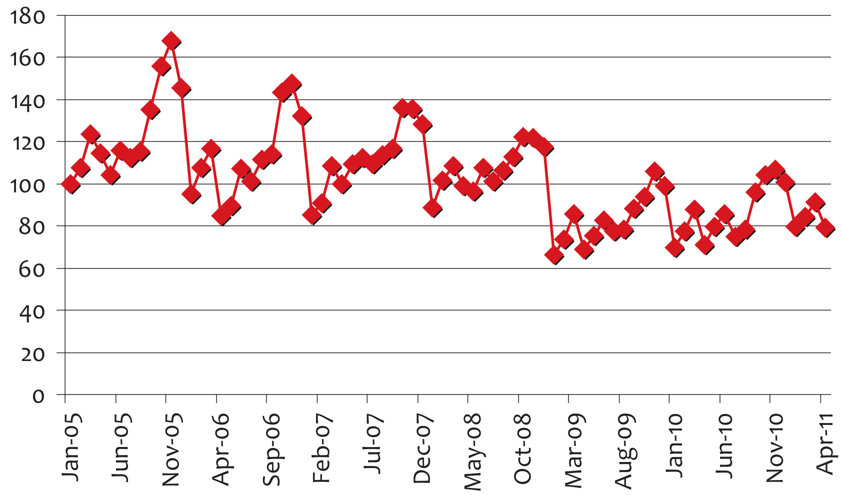
- The meetings attended by senior policymakers in first half of the year showed the dissatisfaction of the farmers with the new agricultural subsidies policy. Farmers obviously complain of small subsidies. We believe that this aspect is less important than the poor economic and technological education of the subsidies' beneficiaries. An absolute priority for the MAFI should be the promotion of training and education of farmers and for this, to adopt a new direction for agricultural subsidies and overhaul the system of formal agricultural education;
- Market and policy evolutions in the first half of the year show clearly that a top priority for the MAFI should be promotion of markets diversification. China, the EU and US – all have huge potential that Moldova producers have not tapped in yet. The private-public initiative that is being successfully tested in the winemaking sector is a model worth replicating in other sectors.

5. Industry

A modest industrial comeback

Data show that the Moldovan industrial sector has been growing spectacularly since the beginning of 2011: in Jan-Apr'11 the total output perked up 9.2% y-o-y, with stronger advances in April as compared to March. However, we maintain our previous claim (see MEGA 3) that such a modest pace of growth will not suffice for a rapid recovery of the output to the pre-crisis, i.e. achieved in 2005, level of production (Chart 6). If this rate of growth persists until the end of 2011, the total annual industrial production will barely arrive at 81% of the 2005 level.

Chart 6. Index of the industrial production, Jan'05=100%



Source: NBS;

As we expected in MEGA no.3, the mining and quarrying industry has advanced at high pace (18.6% in Jan-Apr'11), and its short-term perspectives remain positive. Nevertheless, in mid- to long-term the evolution of the industry will entirely depend on whether the recovery in the constructions sector takes firmer ground; presently, this sector displays a rather elusive return.

The manufacturing sector is on the bright side as well, and the 12.5% y-o-y output growth in Jan-Apr'11 is a confirmation of this, exceeding a bit what we thought in December 2010. However, here the risks are prominent as well, since the short-term indicators vary greatly across the industrial branches of the manufacturing sector. In March 2011 the vegetables and fruits processing industry seems to have entered a more difficult stage in its development (decreasing 16% y-o-y), with downside prospects due to the expected decline in vegetables production in 2011. Considering the see-saw evolutions in the recent months, the immediate perspectives seem quite uncertain in case of the meat processing, dairy products, tobacco processing and paper production. After a difficult first quarter, odds seem to improve in case of textiles industry, one of key industrial clusters in Moldova.

Due to the lack of data, in the MEGA 3 we did not touch upon a very important aspect – the regional profile of the industrial growth in 2010. With relevant data recently released, we took a closer view at them in order to assess how homogeneous the industrial growth was last year across the country and how far are individual regions from recovering to the pre-crisis 2005 level. We discovered that in 2010 only 8 subnational entities out of the 35 analyzed recovered the industrial production volumes and most of them were from the Northern Development Region, while 9 districts were unable to recover at least half of the pre-crisis level (Table 2).

Table 2. Groups of subnational entities by rate of industrial growth in 2006-2010, 2005=100%

Entities that recovered the pre-crisis level	Entities not recovered but growing more than national average
Donduseni, 191% Calarasi, 161% Drochia, 150% Ocnita, 146% Soroca, 146% Falesti, 130% Riscani, 120% Causeni, 101%	Anenii Noi, 97% Ungheni, 93% Mun. Balti, 91% Glodeni, 87% Rezina, 87% Orhei, 83% Cimislia, 83% Mun. Chisinau, 81%
Entities recovering more than half of pre-crisis level but lower than national average	**Entities recovering less than half of pre-crisis level**
Floresti, 79% Taraclia, 73% Telenesti, 71% Gagauzia ATU, 65% Cahul, 64% Briceni, 62% Soldanesti, 62% Criuleni, 61% Leova, 58% Straseni, 52%	Dubasari, 50% Ialoveni, 47% Edinet, 46% Stefan Voda, 45% Basarabeasca, 41% Singerei, 39% Hincesti, 38% Cantemir, 36% Nisporeni, 30%

Source: Expert-Grup calculations based on NBS;

In 2011 energy production sector – as we expected in MEGA 3 – has continued falling, slowly but steadily (-3% in Jan-Apr'11 y-o-y). Implications of this are not straightforward. On the one hand, the 1.8% decline in domestic production of electricity in the first quarter of the year is particularly worrisome on the backdrop of concomitant expanding of domestic demand at an estimate rate of 4.0%. On the other hand, the 4.4% fall in production of thermal energy supplied through municipal centralized systems ultimately reflects the effect of the growing prices for gas imported from Russia, as gas consumption fell by 5% in Q1'11, y-o-y. Interestingly, Moldova has shed its energy dependency on Russia against the background of rising dependency in most of countries in Central and Eastern Europe in the first half of 2011. In the recent two years the rise in the gas price was among the steepest in Moldova. Contracting gas consumption had no visible impact over the level of production in energy-intensive industries. Ultimately, this suggests that realistic tariff levels can play critical role as a policy tool to improve the energy efficiency in the country.

Forecast

- We revise upwards by 1.7 p.p. our forecast of industrial growth, and believe that in 2011 the industrial sector will post a 5.0% growth in output;
- The construction sector evolves slower than we expected, which makes us reduce the mining industry growth forecast from 15% to 12%;

- The manufacture is expected to put a 6% growth this year, supported by advances in the food industry and the textiles, apparel and fur industry;
- Energy production will remain 'in red' in 2011, falling by 6%. The poor condition of the cogeneration power plants remains the main culprit for this performance.

Policy recommendations

- The bleak outlook of the regional industrial recovery proves the case for the sector-wide intervention policies rather than district-tailored solutions. Developing feasibility studies (9 in the first half of the year) is not enough to attract the investors. The lower-tier local public authorities need to play a more active role, such as accelerating the change in land destinations from rural to industrial. At the same time, their capabilities to attract public, private and international funds for construction of the parks are rather low and need to be supported by the MIEPO, Ministry of Economy and State Chancellery. A particular attention has to be paid to the regions included in the lowest-right cell in the Table 1: only in 3 of 9 industrially most depressed districts feasibility studies on industrial parks were performed. The other 6 districts require immediate assistance for the development of the studies, and all 9 regions will have to be offered as priority resources for proper creation of the parks;
- In the first half of 2011 the administration of the state-owned enterprises and the wages of their management staff were among the most publicly debated issues, even though most of the discussions failed to move beyond populist statements. The strategic decision of restructuring/privatisation of the public companies was adopted. At the same time, the Government's insistence on the decision to cap wages of the executive management and boards of directors appear to be completely flawed. Wages for the managers need to remain high or even grow, while sector-tailored management performance criteria designed, adopted and enforced through the proper contracts.

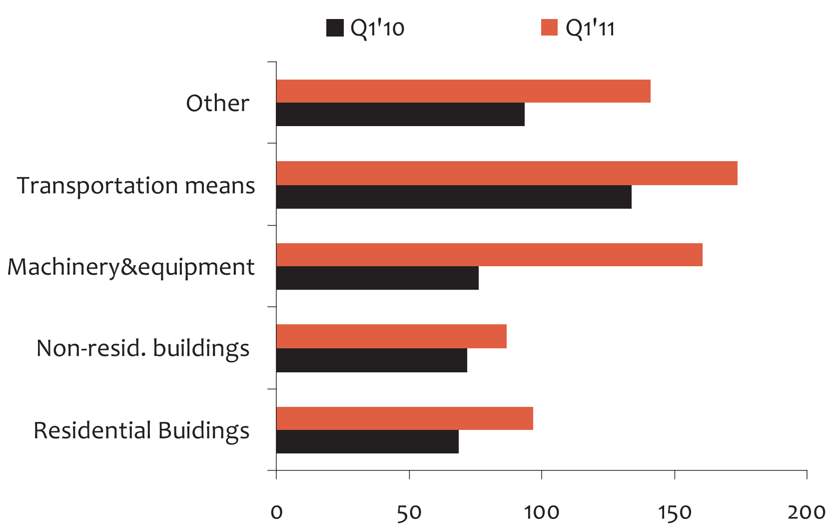
6. Constructions

Tentative recovery with mixed feelings...

In Q1'11 the share of the construction sector in GDP remained fairly constant (2.5% in Q1'10 vs. 2.4% in Q1'11). Yet, in Q1'2011 the sector enjoyed a modest 4% growth, compared to the 23% decrease in the same period of 2010. During Q1'11 the price of construction and assembly works (CAW) also registered an overall increase of 7.3%. It is worth mentioning that in 2008, the price index for CAW registered its first decline since 1993. The rising price index for CAW could be a consequence of the slight growth registered by the construction sector (and increased demand that goes with it). However it is necessary to look at the evolution of this sector's components in order to spot real determinants.

While the amount of the investments in long term tangible assets beat the most optimistic expectations the growth was due to a 60% increase in investments in machinery and equipment and 73% increase of investments in transportation means. Unfortunately, the volume of investments in residential buildings moved in the opposite direction - during Q1'11 the performance of this subsector decreased by 3.2%. The descending trend was even more obvious in case of the non-residential buildings. During Q1'11 this particular subsector fell by 13%, y-o-y (Chart 7).

Chart 7. **Investments in long term tangible assets, % change y-o-y (Q1'10-Q1'11)**



Source: Expert-Grup calculations based on NBS data;

The breakdown of the construction sector proves that the performance among subsectors was very unbalanced. The business sector is indeed recovering, otherwise the investments in machinery and equipment would have grown less than they did. Yet, the companies were even more unwilling to invest their available means in real estate than last year. The explanation behind these figures could be that the main priority of the entrepreneurs at this point in time is to increase the production capacity. This excess capacity would allow them to meet the increasing domestic demand.

As for the evolution of investments in residential buildings, the situation is much more complex. First of all, suppliers on this market apply outrageous margins to the costs they incur with assembly and construction works. As a consequence of this practice the prices for apartments are inflated. However, the fact that most customers are unwilling to pay the requested price does not determine the suppliers to settle for a smaller price because the costs of the residential buildings are usually covered by sales of a share of the apartments. Ultimately the explanation behind the decrease in investments for that subsector becomes quite obvious - with all the estate that has already been built, the suppliers are not willing to make additional investments until the remaining apartments in half empty building are fully sold out.

Speaking of the customers who are obviously fighting a losing battle, it is hard not to feel a little sympathy. Unfortunately, the outrageous market price is only one of the reasons behind the customers' troubles. During the past year the banking sector has been desperately trying to boost sales of a relatively new financial product – home loans and mortgages. Up until now the Moldovan citizens were reluctant to choose this option for financing their future homes, and for a good reason. The credit rates are far from advantageous, some banks offer mortgage loans at rates as high as 14%. Purchasing an apartment under such contract arrangement might boost the ultimate price of the apartment by nearly 100%.

In fact, the purchasing power of the potential real estate buyers is nourished by the remittances and as a result creates artificial market equilibrium. Should the remittances be removed out of the economic model, the market equilibrium would settle for a lower price.

Forecast

- By the end of 2011 the prices for construction and assembly works are expected to achieve an annual growth of 4-5%, as a result of the growing demand for this type of services. This year will mark the re-launch of the pre-crisis trend that is likely to be maintained in 2012;
- We expect investments in machinery and equipment to continue the ascending trend until the end of the year. The growth rate of these investments will be stimulated by the upcoming changes that will no longer allow entrepreneurs to reinvest their revenues at 0% tax. Under such circumstances, entrepreneurs will try to make the most out of the current provisions during the Q3 and Q4 quarters.

Policy recommendations

- Obtaining a construction permit has been a burdensome procedure that could significantly delay the implementation of a real estate project. Fortunately, in July 2010 the government finally approved the law for Authorizing the Execution of Construction Works. According to a study performed by the World Bank the law in question is supposed to reduce the average number of days for obtaining an authorisation from 351 to 147[1]. Now that authorities can rely on the provisions of a normative act, it is necessary to ensure the proper application of the procedures and timelines specified therein;
- Currently the state has no tools for directly diminishing the costs of the mortgage credits. The main purpose of the program "Prima Casa" was to compensate this market failure with a reasonably priced option offered mainly to young families. However this program can only be viewed as the first step of the authorities in trying to ensure the population with apartments. Offering several options of preferential mortgage credits at more or less realistic rates could revive the real estate market.

[1] Quarterly Report April 2008 – June 2008, Business Regulatory & Tax Administration Reform (BIZTAR) Project Moldova http://pdf.usaid.gov/pdf_docs/PDACL997.pdf

7. Services

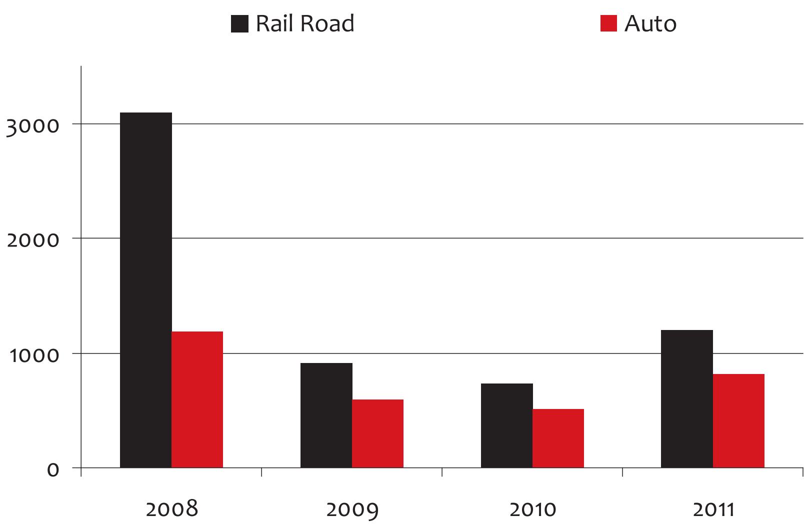
The long and winding road that leads… to recovery

Service sector continued to be the main pillar of Moldovan economic recovery, with its high share in GDP (63.9% in Q1'11). The sector expanded by 6.6% in Q1'11 quite close to the pre-crisis growth rates. This trend exposes all the traits of a service-based economy, though with low value added services being prevalent. Increasing revenues of the population propped up consumption with a highest impact on wholesale and retail trade, repairing of vehicles and personal goods, where the growth reached 19.5%. At the same time, other sub-sectors advanced much slower. The rise in post and telecommunication sector was only 3% in Q1'11 y-o-y (lower than in the same period of 2010).

In the transportation sector the number of passengers travelling during the first 4 months of 2011 is on rise as compared to 2010, registering a 13% increase. Thus, the number of passengers not only bounced back but also exceeded the 2008 level by 1%.

The goods transported during January-May 2011 have registered an increase of 30% as compared to the same period of 2010 (Chart 8), indicating that entrepreneurs are slowly recovering their positions. Yet, the figures cannot be interpreted as an out of common performance since the rate of increase is mostly thanks to the small reference base registered during January - February 2010. It's worth mentioning that during the period under review, the amount of goods transported via rail way posted an annual increase of 35%, followed by the amount of goods transported by auto road - 25% annual growth.

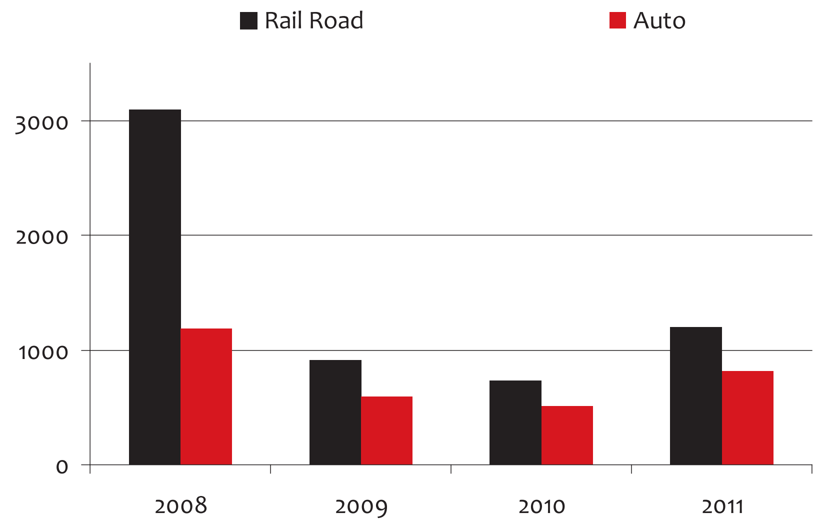
Chart 8. Passengers and goods transported, Q1'06-Q1'11



Source: Expert-Grup calculations based on NBS data;

Looking at the 2009 data it is obvious that the rail road transportation was hit much harder than the auto transportation, nevertheless the recovery of rail road transportation seems to catch up much slower.

Chart 9. **Goods transported via Rail Road vs. Auto, million MDL, Q1'08-Q1'11**



Source: Expert-Grup calculations based on NBS data;

As regards the mobile telephony services, during the Q1'2011, this sub-sector posted a 5.9% increase in revenues as compared to the similar period of 2010. This growth is explained by a 16.4% increase in number of mobile telephony clients, and could be achieved in spite of a 7.9% contraction in the average revenue per user.

Quite the opposite, during the Q1'2011 the number of calls made via land line telephony dropped by 13.1%. Since the number of both, internet users and cell phone users is on the rise, the decrease in number of calls could be explained by the more frequent usage of substitute services. It is no secret that internet and cell phones calls are either more convenient or much cheaper.

Although far from prospering, the hotel services in Moldova have been slowly coming back on track. During Q1'11 the number of tourists placed in collective touristic accommodations (hereinafter accommodated tourists) posted an increase of 11.3%, y-o-y. Thus, after hitting the bottom in Q1'10 with a record low number of guests for this time of the year (lowest figure for the past 7 years), the Q1'11 date shows signs of recovery. The trend is especially encouraging considering that the number of accommodated tourists has constantly dropped each Q1 for the past 5 years. However, it is worth bearing in mind that the pre-crisis number of accommodated tourists in Q1'08 was approximately 31% larger than in Q1'11.

Forecast

- So far, the forecasts made in the previous publication of MEGA (December 2010) seem to hold true in case of mobile telephony services. The growth of this sub-sector is expected to continue to reach 7-8% growth by the end of the year. While the profits of all the players on the market have been constantly climbing, the prices for the supplied services seem to decrease. Nevertheless, considering the tight competition on the mobile telephony market, it's highly unlikely for prices to fall any further. During past 2 years each player appears to be holding fairly constant share of the market. However, the second largest provider has been gaining on average 0.7% per quarter of the number of users. Should this trend continue, by the end of 2011 this market player will supply services to 35% of the mobile telephony users on the market;

- One of the objectives mentioned in "Action plan for eliminating the administrative constraints present in the business environment for 2011"[1] states that the government will diminish the rail road transportation tariffs in Q3'11. Should this intention materialize, the rail road transportation might register an accelerated recovery of 50% before the end of 2011.

Policy recommendations

- Although the amount of goods transported (services supplied to business) is clearly on the rise, the evolution of this sub-sector is not homogeneous. Ensuring an efficient infrastructure and dismantle the roadblocks for the cargo transit via Transnistrian region might have a positive impact on the rail road transportation services in the long run. However, it is fairly important to re-launch the traffic of trains on reasonable terms that will not overwhelm the entrepreneurs with additional taxes or prohibitive controls. Otherwise, the business sector will continue ignoring the rail road routes passing through Transnistria and opt for flexible auto routes;
- According to the World Development Indicators the fixed broadband Internet subscribers (per 100 people) in Moldova was only 5.2% in 2009. While the share might have increased over the course of the past year, it still far from the rates registered by Moldova's neighbour. In 2009 Romania's rate of fixed broadband Internet subscribers constituted over 13%. The access to information (i.e. internet access) is an important indicator pointing to some key social and economic aspects in the country. Considering the market potential and the importance of the internet access, the companies should take steps to increase the rate of internet access among rural share of the population.

[1] Ministry of Economy, http://www.mec.gov.md/node/2594.

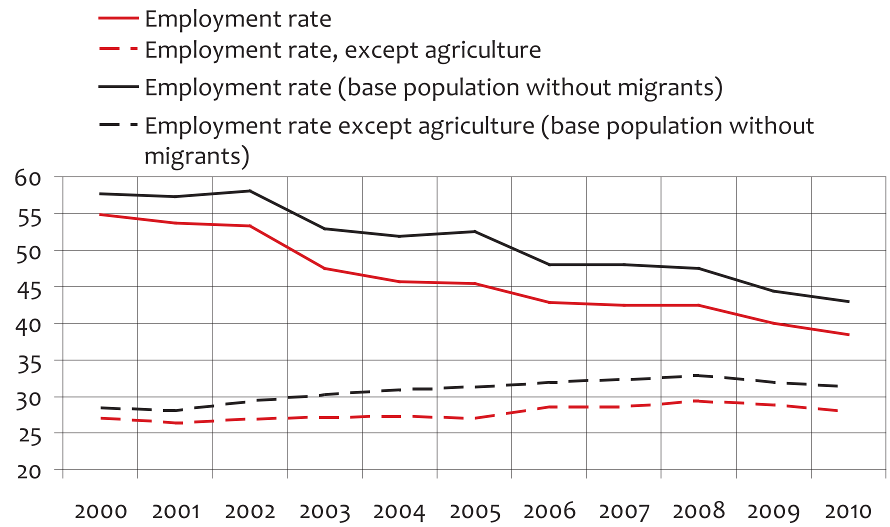
8. Labour Market

Agriculture and migration: chief culprits for the weak labour market?

Moldova enjoys a robust, yet jobless, recovery. In fact, labour market responded with the same lag to the economic recovery as to the economic crisis in 2009. Thus, Moldova closed 2010 reaching new lows in labour participation and employment rates - 41.6% and 38.5% respectively. Significantly lower participation and employment rate in Moldova in regional comparison often appears as something unfathomable to international labour market experts. The most credible explanation is that migration phenomenon distorts largely labour statistics through greater number of working age population non-present in the country. Indeed, exclusion of the migrants from the working age population boost employment rate to 43% in 2010 (Chart 10), but the decrease over the last decade still remains significant - 25%. However, these methods of calculations are not fully appropriate as not all emigrants left Moldova for good and certainly not all of them would be employed in case of return. Most probably, the 'true' employment rate lies somewhere in the middle with little effect over Moldova's position.

The history of decline in employment shows that economic crisis was not the worst period and there were direr years for employment in Moldova. The drop in agricultural employment perfectly illustrates this situation. Thus, when excluding employment in agricultural sector from numerator, the employment rate did not worsen; it even increased prior to the crisis. This decade-long trend of decreasing employment in agriculture will continue since the sector is poorly technically-endowed, unable to provide decent incomes and often exposed to internal and external shocks. Indeed, the decline continued in Q1'11.

Chart 10. Employment rates by different approaches, %, 2000-2010



Source: NBS, EG calculations based on NBS data;

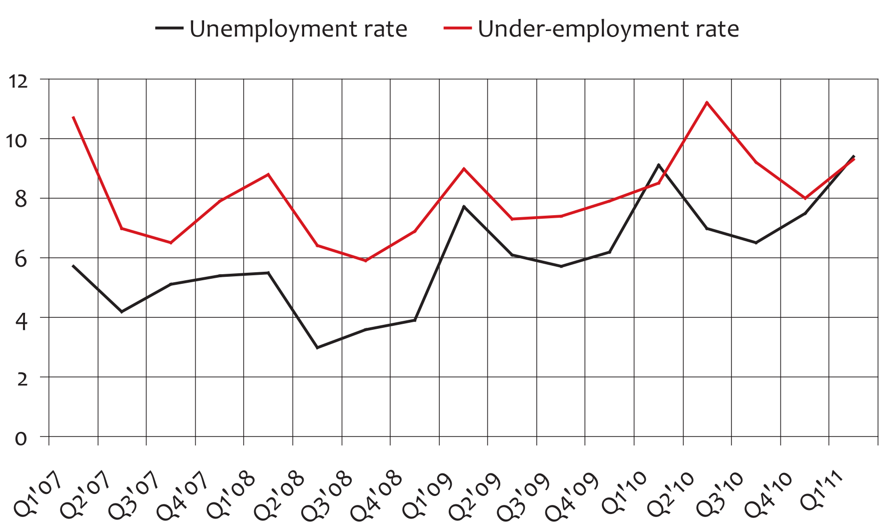
Although the employment in industrial sector was affected by the economic crisis the latest data shows some positive signs. The fact that mostly older and low-educated individuals lost their jobs in 2009-2010 can be treated as a sign of optimization process in some enterprises that mainly shed auxiliary personnel. Similar evolutions took place in other transition countries leading later to productivity gains. In Q1'11 employment in industrial sector already perked up after eight quarters of decline. The employment posted weak but nevertheless important 1% gain in this period.

Defying promising evolutions of last year in construction sector, the 2011 data appear to pip the rosy hopes for this year. In other words, the talk about recovery in the construction sector appears somewhat premature. The growth in 2010 seems to have been generated by finalization of constructions launched prior to the economic crisis. However, as many of these constructions are already finalized and there are few new orders, the sector has slowed down. So did the employment, which fell by 15% in Q1'11. Thus, the recent increase in employment was mainly generated in service sector and namely in trade, hotels and restaurants which responded to higher demand.

During the economic crisis informal employment was used to decrease production costs, though higher share of informal employment (informal employment represented 27% of total employment and 10.4% of wage earners in 2010) occurred mostly within households and agricultural sector. In Q1'11 signs of transition to 'legal' trend could be identified (informal employment went down to 24% and informal employment among wage earners decreased to 8.8%). However, informal employment in formal companies or non-declaration of the whole salary remains a stable feature of Moldovan labour market. Recently, the Government showed its concern regarding this issue; it even elaborated an Action Plan[1] to fight it. As a matter of fact, the Government did not understand that not informal employment and unofficial salaries should be fought, but causes determining this phenomenon (poor quality of services provided by the Government, low confidence in the pension system etc.). Therefore, the Government's goals will remain unattained as tools it employs are not pertinent to the task.

Alternatively, both under-employment and unemployment rates continued to increase in Q1'11, Moldova converging more and more to the theoretical model when decrease in employment is accompanied by increase in unemployment (Chart 11).

Chart 11. Unemployment and underemployment rate, %, 2007-2011



Source: NBS;

[1] Action Plan for reduction of unofficial wages and informal employment as wage-earners approved by Governmental Decision from 2011.

According to National Employment Agency data, in April-May the registered unemployment, which was rising during the last few years, started to decline. This development should be treated with some degree of optimism as the number of vacancies almost doubled from the beginning of the year. Currently, around 45% of unemployed are registered, the share being relatively higher than in pre-crisis period. However, the share of unemployed receiving unemployment benefit went down from 11-13% in 2010 to 8-10% in 2011. After the tremendous increase in unemployment benefits paid (160% in 2009 and 55% in 2010), this became a serious concern for the Government faced with social insurance budget constraints. Therefore, the Government recently undertook some actions in order to decrease the spending on social employment[1]. Firstly, now unemployed are required to show up every 15 or 30 days (depending on the place of residence) at the employment office. It has the intent to eliminate from unemployment scheme people that can actually be outside the country and not really looking for a job. Secondly, unemployed individuals participating in trainings and not receiving unemployment benefit or other allocations for professional training will be given a monthly stipend. It could motivate the unemployed to participate in trainings, as otherwise the participation was very low, due to high transportation costs and/or rental and living cost that could not be covered by unemployed. Thirdly, only individuals with at least 9 month payments to social insurance fund can receive unemployment benefit, a decision that disadvantages young graduates who do not have work experience. Fourthly, unemployment benefit formula was changed, in order to avoid situations when unemployment benefit can be higher than the salary received prior to unemployment and thus, could be a disincentive to look for a job.

Forecast

- In 2011 we expect a stabilisation on the labour market, with an increase in occupation mainly in service sector, which could be offset by negative evolution in agricultural sector. Thus, the overall employment will rise by 1.5%, at best, with a similar increase in hours worked per economy. Unemployment rate will be stable during 2011;
- In short- and mid- term migration will remain a feasible option for those unable to find a job and to earn decent salary in the country. At the same time, we consider that the potential stock of emigrants is decreasing; taking into consideration that in 2010 the flow of emigrants was already close to pre-crisis level we expect a stabilization of the number of migrants. In the future, a possible visa-free regime with EU may boost the number of emigrants, but not significantly; we rather expect a reorientation of migrants from CIS to EU to occur.

Policy recommendations

- Labour market and employment strategies may be a blunt instrument for job creation if business activity is very low. Therefore, the main role of the Government in increasing employment is to improve business climate and ease the burden on the private sector;
- No doubt, human capital is the most important input for the modern economic activity; however, this aspect was largely ignored during the last decade. The reform of education system is sorely needed in order to increase the quality of human capital and ensure that supply of labour force matches the demand. For the latter to occur, the framework for involvement of private sector in formation of human capital through internships, elaboration of curricula is of critical importance;

[1] Law no.56 from 09.06.2011 for amendment and completion of several legal acts

- The Government should be prepared to deal with the social discontent and increase in needs for social payments, after the designed reforms are implemented. Firstly, public administration reform has not finished and will result in the reduction of employees. Secondly, according to the Memorandum signed with IMF, Moldova has engaged to reform its oversized education system. In its turn, this reform will lead to reduction of teaching and non-teaching positions by 5823 units. This will definitely put strain on the labour market; notwithstanding these costs, the reform is necessary.

9. Households

Do remittances still fuel consumption?

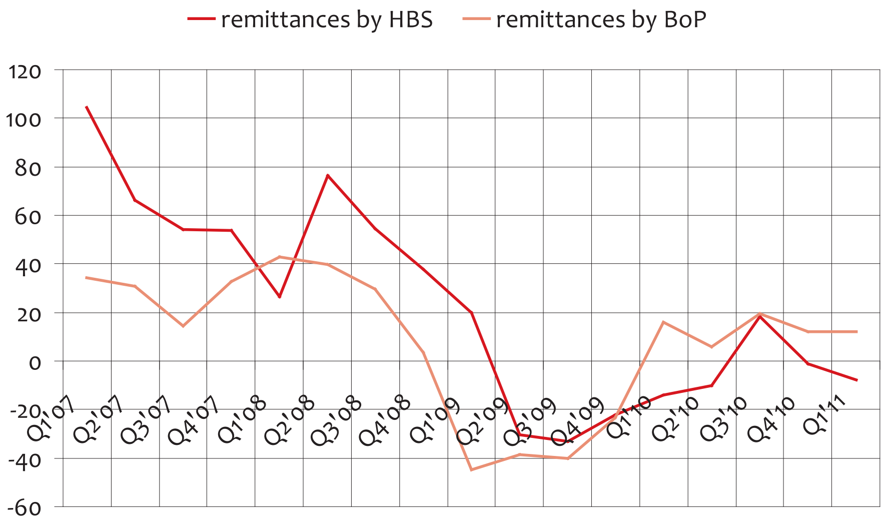
As economic recovery set in, the wages increased in almost all economic sectors. In 2010, the annual real growth was still low (0.7%) due to negative trend of wages in the first half of the year. The upward trend became firmer in the beginning of 2011. Thus, the real wages rose in Q1'11 by 3.3% on average, with the highest increase in agricultural, mining and quarrying and trade sectors. Meanwhile, the wage growth in some top sectors either slowed down or reversed. However, the wage gap among economic sectors widened in 2010 following short-lived crisis-driven contraction in 2009. Currently, wages in 'agricultural' and 'fishing' sectors are more than one standard deviation lower than the average per economy and wages in 'energy, gas and water' and 'financial activities' are one standard deviation above the mean. There were no major changes in this respect for a long period except fading attractiveness of salaries in mining and quarrying sector that were very high during the boom in construction sector.

In 2011 the Government managed to increase the wages in educational sector (by 12.5% in January and another 12.5% hike is expected in September for teaching staff), which are still lower than the average wage in economy. At the same time, wages in health sector fell in real terms, and this might become a source of discontent, as previous increases in the educational system were not matched by wage hikes in the health sector. However, the Government intends to target some categories and soon wages for medical personnel in rural areas should be raised. The hike aims to attract doctors and medical assistants in rural areas, where medical personnel are scarce.

Since 2000 remittances have been an important source of households' income and have largely sustained the economic growth through high domestic demand. According to NBM data, remittances increased between 12% and 20% (12.2% in Q1'11 y-o-y by Balance of Payments (BoP) data and 20% on average in Q1'11 and January-May 2011 by reported transfers in favour of natural persons through banking system). On the other hand, Households Budget Survey (HBS) data show a totally different situation, respondents reported a decrease in remittances on average by 12% per person in Q1'11 y-o-y. Even when adjusted for the number of present population and converted to USD, there is still a decrease of 8% in remittances. Of course we do not expect remittances to have the same value in HBS and BoP, but at least the trends should coincide. In fact, this was the situation before 2009, when remittances grew according to both sources (Chart 12).

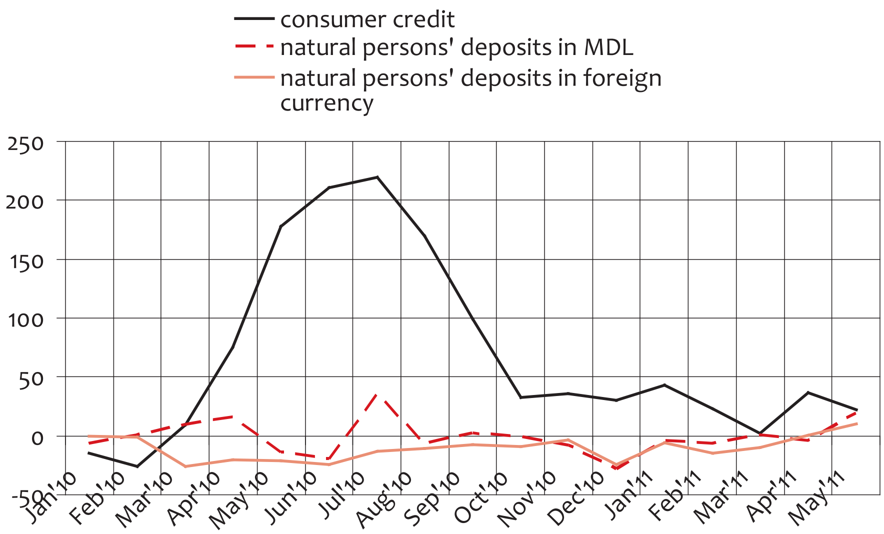
However, consumption definitely grew, and this highly correlates with increase in remittances by BoP source (0.78 correlation coefficient for Q1'07-Q1'11 compared to 0.33 correlation coefficient with HBS data for the same period). Of course, it could have been supported from other sources too: salaries and consumer credit, but here the correlation is even weaker. Despite the rise in consumer credit in five months of 2011 (25%), the amount of consumer credit represents only around 10% of remittances, being much less important for the households. Conversely, savings of population reversed their decline only in May 2011 (Chart 13).

Chart 12. **Evolution of remittances, % change, y-o-y, 2007-2011**



Source: NBS, NBM;

Chart 13. **Evolution of consumer credit and natural persons' deposits, % change, y-o-y, 2010-2011**



Source: EG calculations based on NBM data;

Furthermore, incomes from individual entrepreneurial activities also declined. If the decrease from agricultural activities was less significant and could be attributed to the survey error, but also explained by higher production costs, the drop in non-agricultural income (on average by 25% per person) cannot be ignored in a period when economic activity is rising and businesses are expanding. All these facts raise some doubts about the latest data of HBS.

Forecast

- In 2011 we expect a recovery across all private economic sectors supporting wage growth in the real sector of up to 4-5% on average. In the budgetary sector, the wages in educational sector are set to increase in September 2011. These hikes could well be followed by others in health sector (by the end of the year or in 2012), where wages are still lower than the average per economy. The decision on these rises is to a large extent of political nature and therefore is hard to predict;
- We still believe that remittances are increasing as suggested by BoP and by the end of 2011 they will recover posting a 10-12% annual growth. However, the potential of migration is contracting and starting with 2012 we expect a moderation in the growth of remittances;
- Based on the positive projections on wages, remittances and consumer credit, we expect an increase of 10-12% in retail trade and of around 8-9% in total consumption for 2011. Growing incomes will also allow population to expand their savings that are already on a positive trend.

Policy recommendations

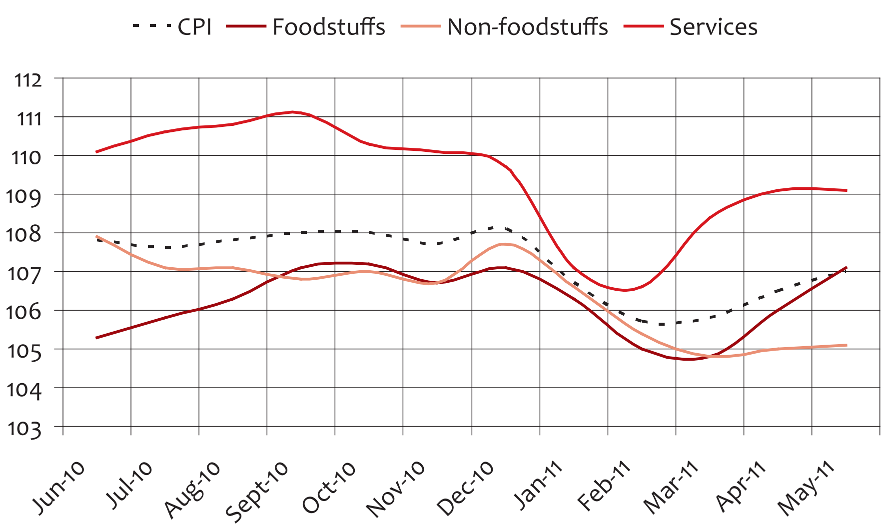
- This analysis indentifies some serious problems in statistical data in Moldova. These shortcomings impede proper understanding of the situation in Moldova, making credible forecasts and designing sound policies. Therefore, it is very important to revise all data sources, to find weak and strong points of each data source and to improve them, so that a clear picture is obtained;
- Wages in public sector should be increased in mid-term in order to ensure the quality of public services and fight corruption. Of course, these should go hand in hand with performance monitoring in public sector in order to avoid moral hazard. Despite the budgetary constraints, the optimisation in public sector may allow for an increase in wages in mid-term;
- Incomes from remittances are approaching their maximum potential growth rate and the Government should take advantage of these few years to promote investments: both private and public;
- Social protection policy should be revised as social expenditures are very high but failing to reach the most vulnerable groups. Thus, implementation of means-tested mechanisms should continue and become the only method used. The burden on the budget will increase due to demographic factors, labour market trends and an eventual return of the migrants with no contributions but with claims to the pension fund. Therefore, the reform in the pension system is crucial and should start as soon as possible.

10. Prices

Main trends: an 'inflation' of services and foodstuffs

The annual headline inflation (CPI) declined from 8.1% at end-2010 to 7% in May 2011 due to tighter monetary policy and lower growth rate of regulated tariffs for certain services. Still, the biggest contribution had the services sector as a result of the new tariffs approved in February 2011 for natural gas (+14.3%) and heating (+12.4%), and for electricity (+0.8% - +11.3%) approved in April 2011. Thus, the overall pick up in utilities' tariffs in this period was 9.1%, wiping out of the boon for poor households. Given the second round effects of higher energy prices, the transportation costs increased, fueling the prices for foodstuffs (+7.1%). The latter have been moving upwards since March 2011 and are also driven by regional price hikes for most of the foodstuffs. At the same time, the overall foodstuffs inflation was mitigated by the good harvest and increase in supply of potatoes and vegetables, which became cheaper by 11.7% and 5.1%. Non-foodstuffs increased at a lower rate (+5.1%), being mainly driven by dearer fuels (+17.2%). Importantly, due to administrative measures undertaken by the Government, the prices of drugs decreased by 7.7%, y-o-y. All in all, the recent inflationary overshooting is mainly driven by the prices for services and foodstuffs which account for 62.9% of the CPI basket (Chart 14).

Chart 14. Evolution of CPI and its main components, y-o-y, %

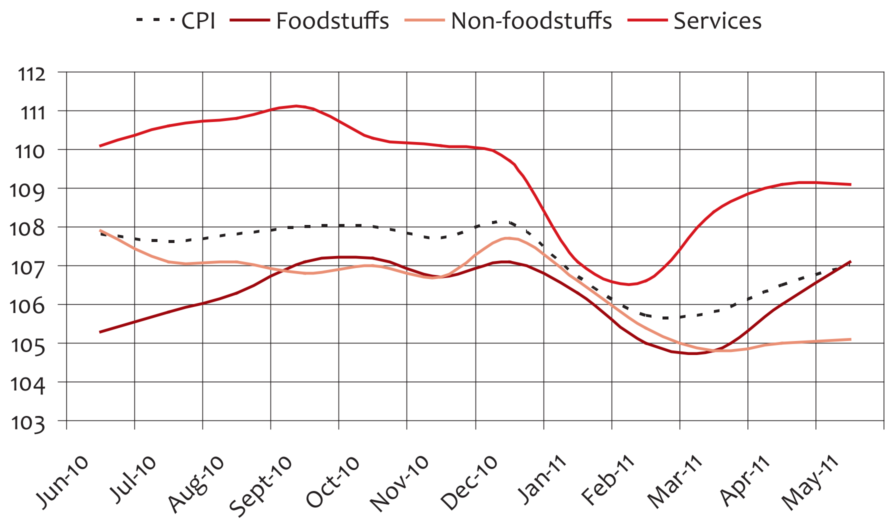


Source: NBS;

Although, the current inflation is kept single-digit, it implies significant economic costs. Given the opportunity costs of holding money and erosion of purchasing power of the population, the overall inflation costs can be estimated at about 4.7% of GDP after the Q1'2011[1].

The main inflationary peril in the long term is term economic contraction caused by higher uncertainty and credit costs (even in real terms) and which undermines investment activity of firms and dents confidence in the national currency. Chart 15 reveals that despite some positive effects of inflation on the industrial activity in the 12-months time span, the inflationary repercussions are much more persistent (1-3 years).

Chart 15. Simulated impact of 1 p.p. increase in annual CPI on the annual industrial production index, VAR model

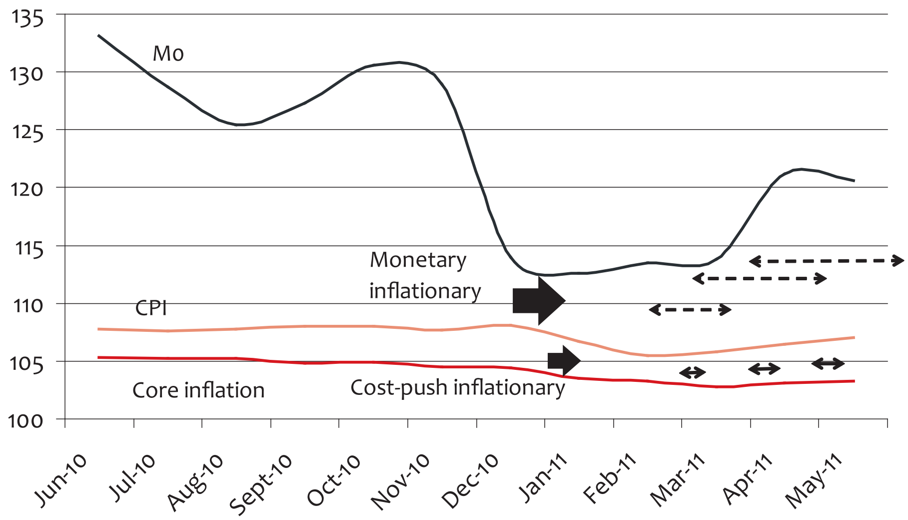


Source: Expert-Grup calculations;

Although the central bank argues that prices are fueled mainly by cost-push factors driven by rising energy and food prices on international markets[2], in our opinion the current inflationary phenomenon is based on a mix of cost-push and demand-side pressures. The rapid credit expansion and a robust economic recovery based on increasing domestic consumption fueled by remittances gives credence to this opinion. The argument of strong monetary inflationary pressures is corroborated by the visible increase in money in circulation caused by low interest rates as well as overall economic growth. The cost-push factors are revealed by the persistent discrepancy between headline inflation and core inflation[3] (Chart 16).

[1] Inflation costs = Money in circulation + current account deposit (M1) * (Real interest rate + CPI).
[2] Inflation Report no. 2, May 2011, NBM.
[3] Core inflation – CPI excluding goods and services with regulated prices, fuels, foodstuffs and beverages.

Chart 16. **CPI, money in circulation (M0) and core inflation, y-o-y, %**

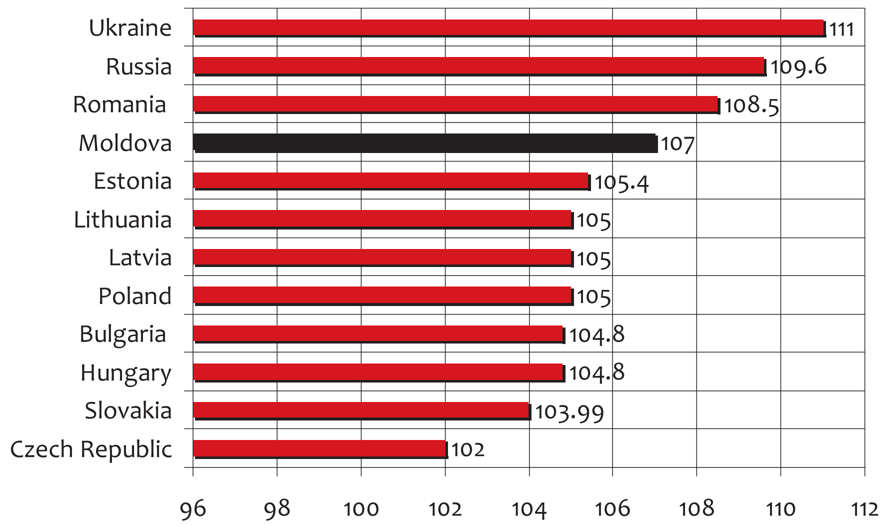


Source: NBM and NBS;

The main culprits of this discrepancy are related to a series of so-called non-monetaryinflationary factors. These factors are particularly risky as they can hardly be controlled by the monetary authority and, usually, affect the price level in two rounds: the input prices and the final products made of those inputs. The main cost-push factors which appeared in 2010 and persist in 2011 are:

- *Worsening of regional weather conditions*, which spurred the prices for wheat, sugar and vegetable oil;
- *The increase in energy prices.* Particularly, higher prices for natural gas motivated the regulated services to adjust (central heating +34.6%, gas +23.6% and electricity supply +10.3%);
- *Increase in prices for other inputs.* The spike in fuel prices inflated the production costs in many other industries. As a result, in May 2011 the industrial production prices index for domestic market was 8.3%, y-o-y; at the end of the Q1'2011 the sale prices of agricultural products by farmers increased by 17.3% and the prices for construction-assembly works by 7.3%, y-o-y;
- *Imported inflation.* The strong dependence of the Moldovan economy on imports, given its consumption-led economic growth, made it highly vulnerable to external inflationary pressures. Thus, the regional price spikes directly influenced the domestic CPI. Chart 17 shows that, although the price level is relatively high in Moldova in comparison with CEE countries, it is lower than in its main trading partners (Romania, Russia and Ukraine). Still, it is worth noting that the effects of imported inflation were mitigated by the national currency appreciation in comparison with the US dollar and Ukrainian hrivna.

Chart 17. Annual CPI in several countries in region , %, May'11



Source: National Statistical Bureaus of selected countries;

Forecast

- According to our model, the annual headline inflation is likely to increase up to 7.5% by the end of 2011. However, taking into account the expected pick up in imported natural gas and raising international food prices, the y-o-y CPI is likely to increase up to 8.0%-8.5%;
- The current inflationary overshooting appears to be temporary, meaning that by end-2012 the annual CPI will fit into the central bank's target of 5.0% (±1.5 p.p.), unless 'black swan' type of events occur.

Policy recommendations

- The main inflationary risks are stemming from external economic environment, particularly from increasingly dear energy and food. It could inflate further the production costs and give a fillip to the domestic price level. This type of pressures is particularly challenging, as the central bank can control only their second round effects, through increase in prices for raw materials. Therefore, decreasing the dependence on imported foodstuffs accompanied by development of domestic production should be one of the Government's strategic objectives.

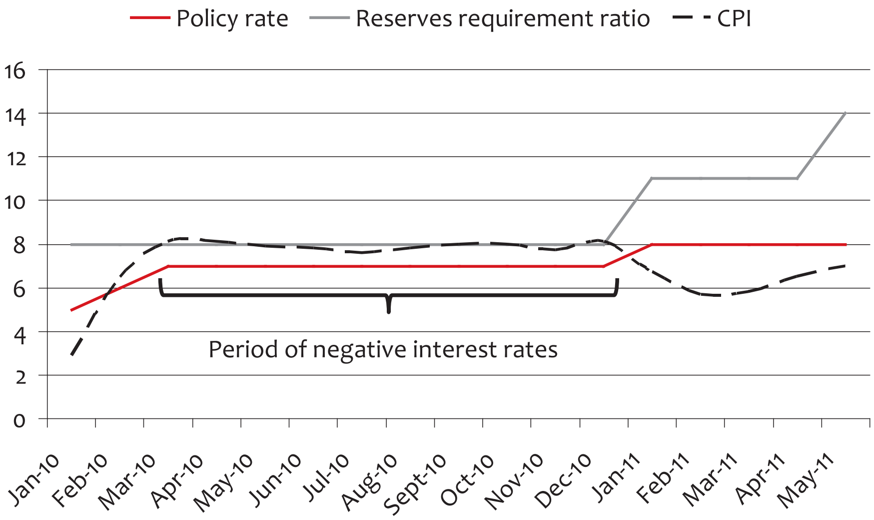
11. Monetary Policy

Looking for the right 'hammer' to strike the monetary 'nail'

Balancing between price stability and economic growth

After a period of negative interest rates (2010), the monetary authority started to gradually wind down its accommodative stance, following its inflation targeting strategy. Thus, the central bank, recently, began tightening its monetary policy in order to keep inflationary expectations well anchored and steer the annual CPI within the targeted interval (+5%, ±1.5 p.p.). It involved an increase in REPO rate from 7.0% to 8.0% at end-2010 and a two-stage increase in reserves requirement ratio (RR ratio) from 8% to 11% in February and from 11% to 14% in May 2011 (Chart 18).

Chart 18. Annual CPI, policy rate and reserves requirement ratio, %



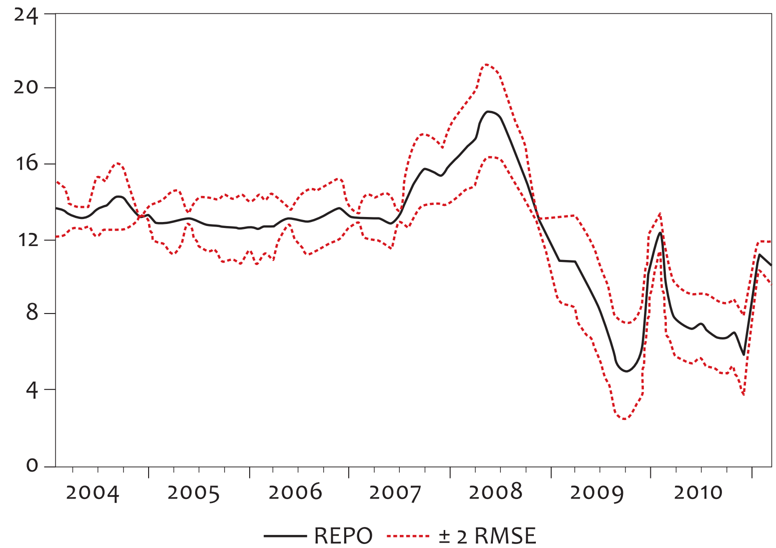
Source: NBM and NBS;

This monetary policy rebalancing confirms the fact that the central bank is aware of mounting demand-side inflationary pressures. Thus, we see some contradiction between its words and deeds, which either denotes attempts to promote an unpredictable neo-classical monetary policy or some internal issues related to planning and carrying out the decision making process. Additionally, National Bank of Moldova (NBM) actions can be motivated by the second round effects of energy and food inflation. It also reveals a visible improvement of the economic situation which, normally, calls for a countercyclical reaction from authorities.

Furthermore, this balancing act is explained by NBM awareness of strong cost-push factors which are out of its influence and, usually, are short-run effects of some external price shocks. Chart 19 clearly illustrates that after a period of ultra-lax monetary policy amid economic recession, the central bank's monetary policy is still easier than before the crisis.

Although the central bank's main monetary policy instrument is the REPO rate, NBM resorted more intensively to reserves requirement ratio as a tool for keeping inflationary pressures in-check. This approach was motivated by shallow money market and slow transmission mecha-

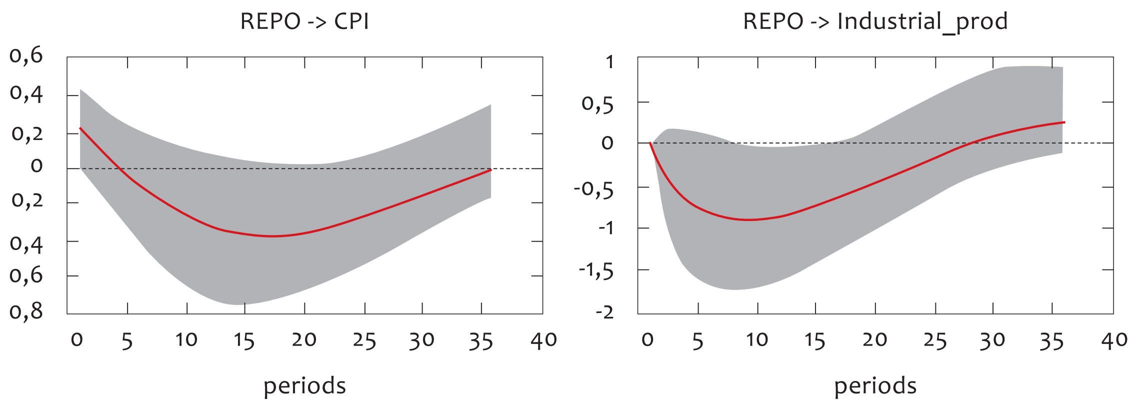
Chart 19. **NBM reaction to inflationary pressures, state space model[1], 2004-2011**



Note 1: higher value implies monetary policy tightening and lower value – monetary policy loosing;
Note 2: RMSE is the possible variation of state space model within a ±2 p.p;
Source: EG calculations;

nism. Hence, due to its sharper and more immediate impact, the RR ratio is a stronger weapon against inflation. As shown by Chart 20 and Chart 21, on average, a 1 p.p. increase in REPO rate leads to a decrease in annual CPI by about 0.4, while the RR ratio has a twice stronger effect. In both cases, the maximum impact is felt in 4-5 quarters.

Chart 20. **VAR modelled impact of 1 p.p. increase in REPO rate on CPI and industrial production index, y-o-y**



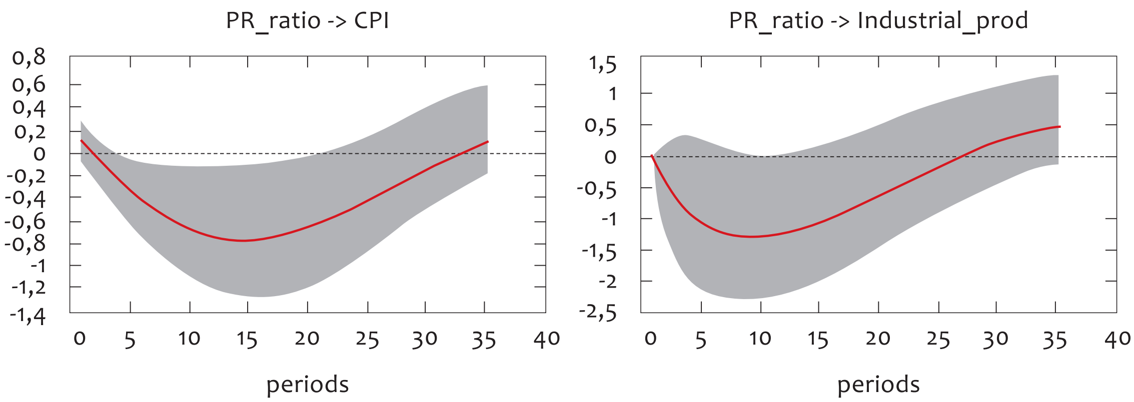
Source: Expert-Grup calculations;

However, we would like to highlight several major risks related to the frequent use of RR ratio as a monetary policy instrument. First of all, its causes a stronger economic contraction: 1 p.p. increase, on average, dents industrial growth by 1.3 p.p., while in case of REPO the impact is about

[1] $REPO_t = \beta_{1t}(CPI_t - hp_{CPI_t}) + e_t$
$\beta_{1t} = \beta_{1t-1} + u_t$

0.8 p.p.. Secondly, in the long run, it stirs more stress among commercial banks, with more negative and persistent effects on the lending activity.

Chart 21. Modelled impact of 1 p.p. increase in RR ratio on CPI and industrial production index, y-o-y



Source: Expert-Grup calculations;

Besides the REPO rate and RR ratio, during the first half 2011 the central bank actively used its open market operations for wiping out the excess liquidity from the system. Thus, in May the average daily stock of sold NBM certificates was MDL 3318.1 million – a level similar to the previous year. Additionally, in May 2011, for the first time since the central bank opened a special credit line for commercial banks, there was no credit granted, meaning that commercial banks have enough liquidity and are well-capitalized.

Moving towards a free-floating exchange rate regime

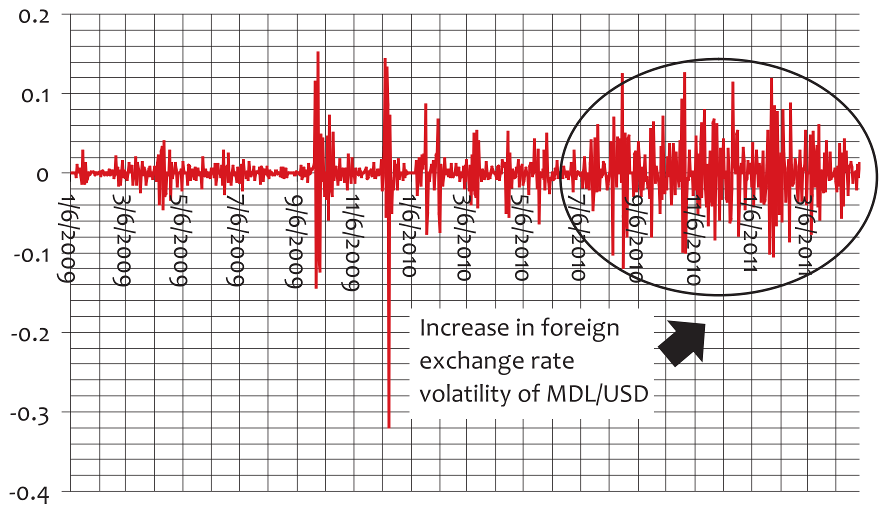
During the first five months of 2011 the central bank significantly reduced its interventions on the foreign exchange market, a move that fuelled the exchange rate volatility (Chart 22). Thus, NBM purchased an equivalent of USD 14.4 million and sold - USD 3.5 million. In comparison with the previous year, the total volume of interventions decreased more than four-fold.

This shift in foreign-exchange policy is in line with the monetary policy strategy for 2010-2012, since the previous actively managed free floating regime was not in line with the central bank's inflation targeting regime. We expect, however, that NBM will keep this volatility within a certain band, reserving the right for more active interventions in case of some abnormal exchange rate fluctuations. Additionally, given the anticipated increase in foreign currency inflows fueled by surging exports and remittances, the central bank could interfere on the foreign exchange market. Thus, it could purchase the excess amount of foreign currency and, in this way, supplement its international currency reserves and prevent an over-appreciation of the national currency. After the first half of 2011 the national currency strengthened in nominal terms in comparison with the US dollar by 4.7% due to a strong increase in exports and remittances. However, Moldovan Leu weakened compared to the EURO currency by 3.8%, as EURO appreciated strongly on the FOREX.

Forecast

- The healthy economic recovery implies higher demand-side inflationary pressures which will motivate the central bank to continue tightening its monetary policy;
- The national currency strengthening will temperate, as the central bank could increase its purchases of excess foreign currency and expand its international currency reserves.

Chart 22. **Daily evolution of MDL/USD parity, second order differencing**



Source: NBM and Expert-Grup calculations;

Policy recommendations

- During the first half of 2011 it became clear that the economy almost recovered and, now, the main priority is to ensure that growth is sustainable and balanced. Therefore, the central bank should continue making its monetary policy less accommodative and concentrate entirely on its inflation targeting strategy. It could imply a gradual and predictable increase in its main policy rate which, in turn, could mitigate the mounting demand side inflationary pressures. Additionally, it would appropriately address the second round effects of recent surge in energy and food prices;
- The NBM should keep its RR ratio at a constant rate as long as possible, while resorting more frequently to REPO rate. Obviously, in a short-run, RR ratio is more efficient and seems more attractive for NBM. However, it implies significant medium and long-term risks, undermining the credit activity of commercial banks. At the same time, it will consolidate the credibility of REPO rate as the main monetary policy instrument and, therefore, improve the interest rate transmission process;
- The monetary policy should ensure a manageable credit expansion and a non-inflationary economic growth which could effectively anchor inflationary expectations. Therefore, the central bank faces the old dilemma of steering the price level to the targeted interval, while keeping adequate conditions for the economic take-off. Given the necessity to completely switch to an authentic inflation targeting strategy, we argue for a more assertive reaction against inflationary overshooting. Additionally, an efficient monetary policy does not explicitly target the economic growth objective, which should, primarily, be the Government's priority. NBM should rather ensure a balanced and a non-inflationary economic growth;
- Traditionally, the monetary policy efficiency in Moldova is undermined by a series of structural issues, such as the underdeveloped capital markets, possible cartel arrangements on particular markets, lack of enthusiasm of commercial banks towards lending activity against the backdrop of liquidity glut. There was no major progress in this direction since the last MEGA issue (e.g. the new law regarding the capital market wasn't approved yet; there were no major actions against the possible cartel arrangements etc). Therefore, we call, again, for wider involvement of other public institutions (e.g. National Agency for Competition Protection, National Commission of Financial Market, Ministry of Economy etc), in order to appropriately address this systemic deficiencies.

12. Budgetary Policy

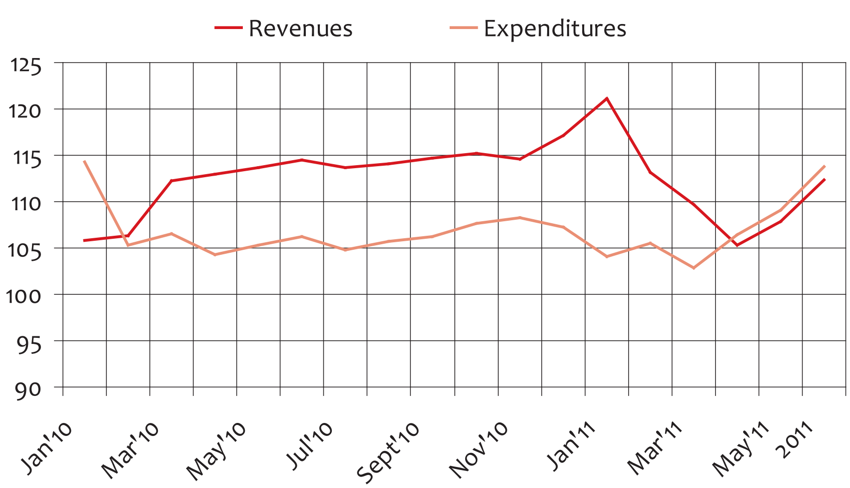
The deficit has been significantly reduced but it is still far from being sustainable

In 2010 the National Public Budget (NPB) reached a more balanced state, while the global revenue exceeded the levels before the crisis and the budgetary deficit dropped to 2.47% of GDP (vs. 6.35% in 2009). The global revenue recovered completely even exceeding the pre-crisis level by circa 8%. This result is surprisingly good, especially taking into account the initial government forecast for 2010.

In general terms the structure of fiscal revenues in 2010 remained the same as prior to the crisis. Still, it should be mentioned that the share of direct taxes (excluding social contributions) reached approximately 10.5% of fiscal revenues maintaining this negative trend throughout the first months of 2011. Even though there are no guiding standards, this share seems very low, but fully reflects the Moldovan economic growth model. By comparison this share is more than twice smaller than in Bulgaria, which has the lowest share among the EU countries.

From February 2010 to March 2011, the revenue growth rate exceeded that of the expenditures (Chart 23). This trend has reversed since April when expenditures have exceeded revenues by slightly more than 1 p.p. So far this does not jeopardize the planned parameters of the 2011 budget, since the budgetary law for 2011 was approved at the end of March, while before that the level of expenditures was under the limits set by the 2010 budgetary law.

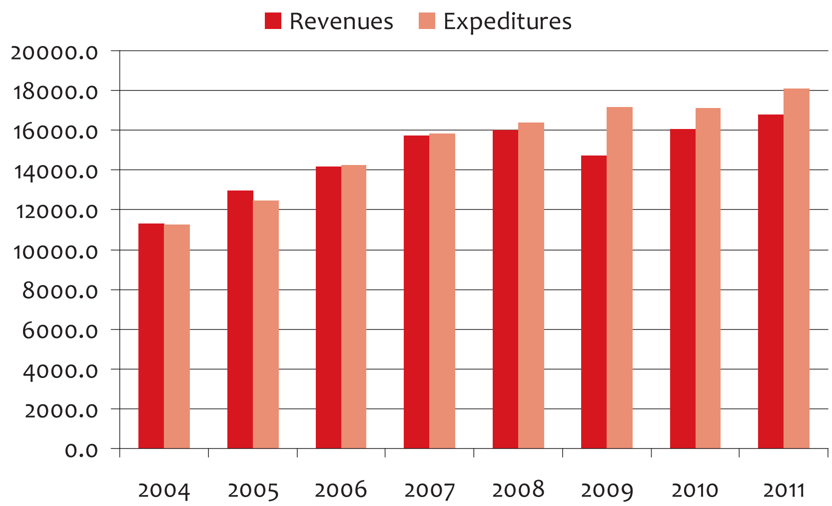
Chart 23. National public budget revenues and expenditures, y-o-y % change



Note: 2011 - forecast;
Source: Ministry of Finance and Expert-Grup calculations;

In 2010 total expenditures fell by 0.17% in real terms as compared to the level of 2009 (Chart 24). In fact the contraction of real growth rate of the expenditures started prior to the crisis. Maintaining a real positive growth for 2011 is very important in terms of achieving the Government's objective of f real wage growth by 3% for budgetary employees. The evolution of the inflation rate and budget revenues for the first 5 months shows that this objective can be achieved.

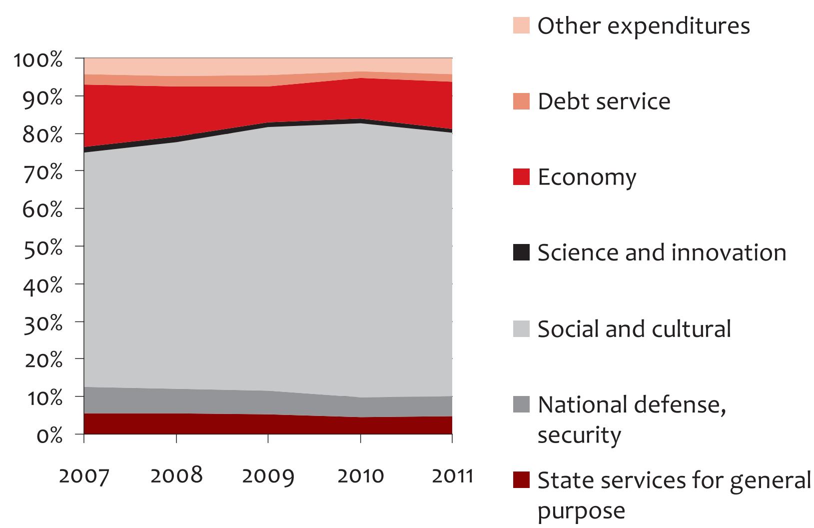
Chart 24. Evolution of public revenues and expenditures in 2004 prices, million MDL, 2004-2011



Note: 2011 – forecast;
Source: Ministry of Finance and Expert-Grup calculations;

The year 2010 practically did not bring anything new in the structure of the National Public Budget expenditures when it comes to the sectors with significant weight. At the same time the share of the expenditures for economy in total expenditures increased by 1.3 p.p. (Chart 25); this positive trend is also observed in the budget 2011 as the share is estimated to grow by another 1.9 p.p. Nonetheless, benefits from this change can be achieved only if these expenditures reflect long term policy priorities, and are immune to short-term political influences. At the same time in the first 5 months the level of expenditures for economy is much lower than planned and can affect the implementations of the projects in these sectors. One of the causes can be the delay in the approval of the budgetary law.

Chart 25. Structure of NPB expenditures, % of total, 2007-2011



Note: 2011 – planned;
Source: Ministry of Finance and Expert-Grup calculations;

The downward trend of capital investments' share in total expenditures that started in 2007 apparently ended, and, by the end 2010, this share increased by 0.6 p.p.. According to the Ministry of Finance estimations, the positive trend will continue throughout 2011, as the share of the capital expenditures is set to increase by approximately 1.2 p.p. This positive step shows the Government's willingness to put more emphasis on the development of public sector. But increase in capital expenditures should go hand in hand with reforms in this sector aimed at its downsizing and more efficient use of public assets in order to make the sector self-sustainable, at best, or to halt its degradation, at least.

While in 2009 the level of transfers from the State Budget (SB) to the State Social Insurance Budget (SSIB) in order to cover the SSIB deficit reached 10.8% of its total expenditures, in 2010 it dropped to 9.8%. The approved 2011 budget aims at trimming these transfers to almost 6.6% of total expenditures and this objective seems to be palatable if current budgetary trends are maintained. Still, taking into consideration the very low level of payments (pensions and other allowances) from SSIB, and the demographic trends it is clear that SSIB will not be able to become self-sustainable in short and long perspective.

For 2012 the Ministry of Finance plans to significantly amend the fiscal policy. The most important amendments are the reintroduction of the income tax for corporations, the establishment of a flat income tax for notaries, lawyers, bailiffs and mediators, as well as some changes regarding real estate tax. All the measures envisaged for 2012, are expected to give an increase in the NPB revenues of 1.7 billion MDL; the reintroduction of income tax for economic entities alone will generate approximately 1 billion MDL. We believe that this measure is well justified and will have a positive effects not only on the State Budget, but also on the budgets of territorial-administrative units (TAUs). Taking into account the current political environment, there is an imminent risk of 'politicizing' these reforms for immediate political gains, which could undermine their effectiveness in the long run.

Forecast

- The fiscal policy for 2011 seems to comply with the parameters set in 2010, except for the 50% increase in excises for alcohol and tobacco. Thus, major changes in the income structure of 2011 are not expected, while the income growth will not exceed the 2010 growth rate;
- The developments during the first 5 months of 2011 do not show any signs that would hamper keeping the budget deficit at bay (1.9% of GDP). Nevertheless, the conservative estimation of Expert-Grup for the budgetary deficit is approximately 2.3% of GDP by the end of the year.

Policy recommendations

- In 2010 the share of expenditures in GDP was approximately 41%. In the EU this share varies from 34% to 54%. We believe that the main criteria that justify the level of public spending are the ability to manage the public sector and the level it contributes to the development of the society. According to these criteria the public sector in Moldova is quite large. The available resources are not sufficient to maintain the public service and infrastructure, let alone to develop it. Thus, the government should implement measures regarding the optimization of public sector size;
- The already started reforms aimed at an efficient use of public resources by increasing the managerial and control capacity are absolutely necessary. Introduction of performance audits represents an important step in that direction. At the same time, the Ministry of Finance has to develop the tools necessary for the assessment and self-evaluation of the public bodies regarding the obtained results and the use of resources. Also,

public bodies/authorities need to publish a compulsory and detailed report on the use of public resources. All these actions are fundamental and without them, there is a risk that the rest of the reforms will fail or will be less efficient;

- Social assistance should be better targeted and based on the means-tested financial assistance schemes. The high level of undeclared wages represents a critical impediment, thus it is mandatory that measures are taken in order to reduce and eliminate this negative phenomenon. At the same time this is a long-term process. Therefore it is necessary to elaborate complex measures suitable for the current environment, thus ensuring a fair distribution of social funds to those in real need;
- It is essential to analyse the impact of the current fiscal policy that does not rely on direct taxes (low property and income tax) and to assess if the initial goals have been reached, as well as factors that determined the result. This analysis should be taken into account when developing the new long-term fiscal policy, which will aim at achieving balanced budget against the backdrop of local decentralization reform and the imperatives of economic development;
- The income tax paid by individuals in the Territorial Administrative Units (TAU) budgets of companies' residence, separates the taxpayer from the actual place of use of public services provided by the local public authorities of individual's area of residence. At the same time this creates unjustified differences in the level of revenues between TAUs. We believe that individuals should pay income tax to the local budget according to their area of residence and not of that of company. This measure is necessary and is especially justified in the light of reintroduction of the corporate income tax.

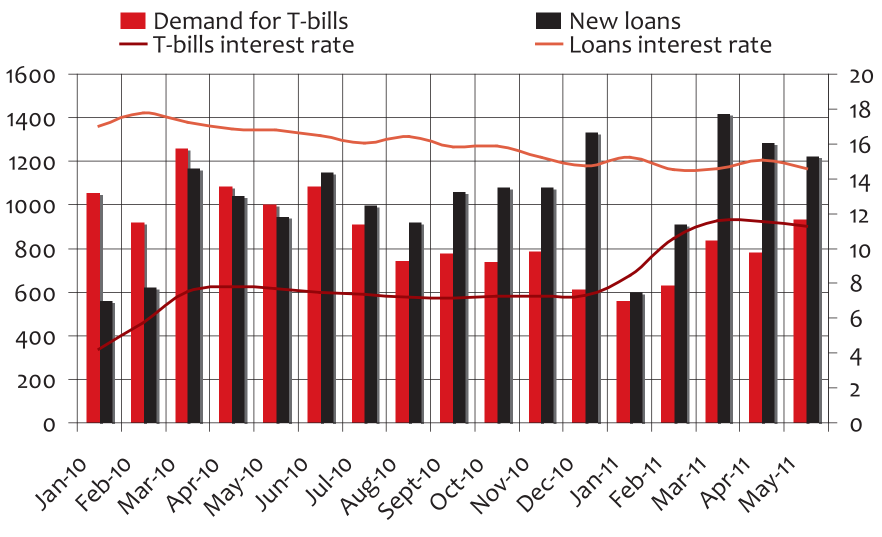
13. Financial Sector

Gradual improvement, but still long way until full recovery

Flying from safe haven to profits' paradise

Amid a healthy economic growth and improvement in macroeconomic expectations, the commercial banks are gradually switching from crediting the Government to crediting the real sector. Thus, in five months of 2011 the demand for T-bills plummeted by about 30% y-o-y, paralleled by a robust revival in firms and households lending (+25.4% in national and +29.4% in foreign currency). This trend was spurred by constantly falling cost of credits, which fueled the demand for bank loans. Moreover, higher interest paid on T-bills following monetary policy tightening, did not curb banks' flight away from safety. This penchant for risk confirms again banks' improving expectation towards the prospects of economic recovery. Importantly, Chart 26 reveals a clear narrowing of risk premiums, as the difference between the lending and T-bills interest rates halved from the beginning of the current year (6.76 p.p. to 3.32 p.p.). We deem this augurs well for further credit revival.

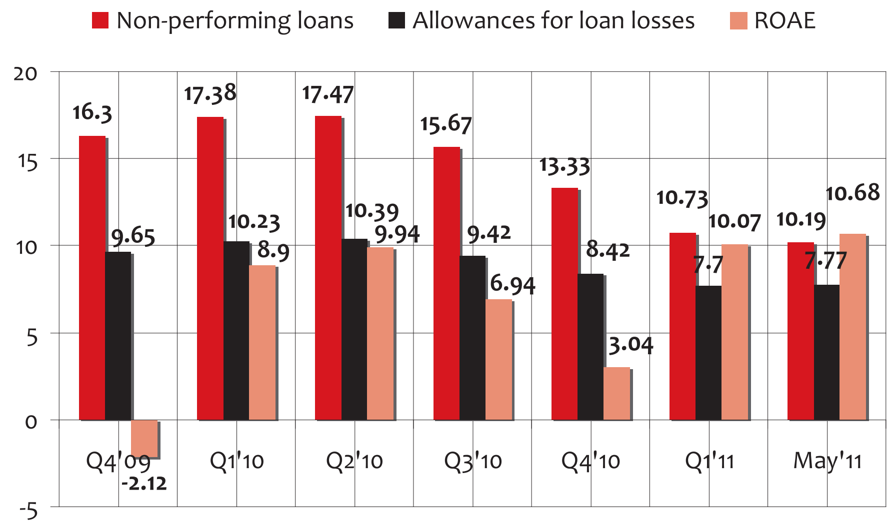
Chart 26. Banks' demand for T-bills and new loans in national currency, MDL mil. (left) and T-bills and lending interest rates, % (right)



Source: NBM;

This fully-fledged expansion of credit significantly improved the overall financial situation in the banking sector. Thus, majority of commercial banks managed to clean up their balance sheets and increased the quality of loan portfolios, which fuelled their profitability. Additionally, the share of allowances for loan losses in total bank credits dropped, which reveals an improving structure of non-performing loans and their lower burden on banking activity (Chart 27). Still, there are few problematic banks with negative profitability which are less successful in managing their toxic assets. However, these problems are likely to be temporary, as under the vigilant monitoring by NBM these banks could catch up with the main trend in a short-run perspective.

Chart 27. Shares of non-performing loans and allowances for loan losses in total bank loans and ROAE, %, 2009-2011



Source: NBM;

Despite signs of recovery, the banking sector is far from the pre-crisis situation as it struggles with a series of structural issues. Thus, the share of non-performing loans in total loan portfolios is over three times higher, revealing poorer bank assets quality; the profitability is less than half of the pre-crisis level, while the market concentration is much higher (Chart 28).

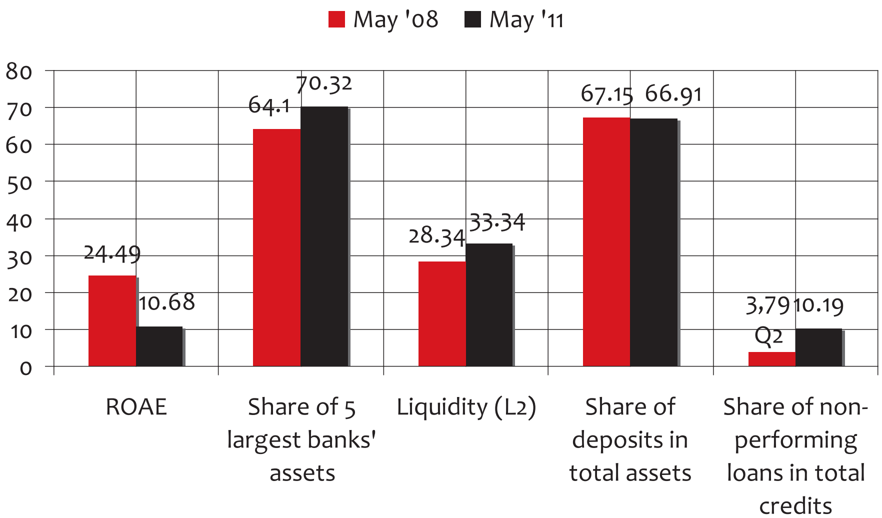
Commercial banks are still hoarding cash, while remaining quite vigilant in their lending activity. It is reflected in liquidity levels higher than before the crisis which threaten the profitability indicators. Thus, the biggest beneficiaries of recent credit revival are the largest companies, with good credit history and stable and diversified outlets. On the contrary, banks remain reluctant about lending to medium and especially small enterprises, which face the chronic problem of poor access to credits. Another crucial issue is related to low efficiency of banking activity. Since 2010, the efficiency proxy[1] hovers around 160 points, while in end-2008 it was 187.6 points. It is worth mentioning that Moldovan banking sector efficiency is one of the lowest in the region and is one of the main factors explaining the high credit costs[2].

Due to the robust economic recovery and surging demand-side inflationary pressures, the central bank gradually trims down its monetary accommodative stance, by increasing its main policy rate and required reserves ratio. Our empirical estimation shows that this monetary policy tightening implies a low impact on the banking system (Chart 29).

Due to abundance in liquidities, a 1 p.p. increase in REPO rate will increase in 3 months the cost of credits up to 0.2 p.p., while very soon this effect will die out. The impact on the quality of banks' assets, which can be used as a proxy the share of non-performing loans in total bank's portfolios, is more sizable and persistent. However, the full impact could be seen in about 20 months – a period in which the commercial banks could appropriately balance their balance sheets in order to mitigate this shock.

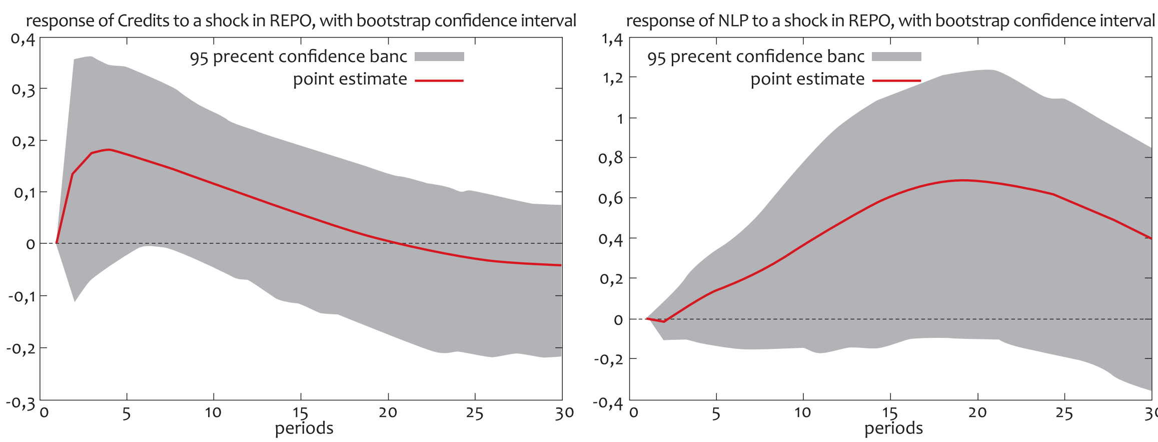
[1] (net financial income + non-financial income)/non-financial expenditures.
[2] Lupusor A., "Why the Cost of Credits are High in Moldova?", Expert-Grup, 2011.

Chart 28. Main indicators of the banking sector, %



Source: NBM;

Chart 29. The simulated impact of a 1 p.p. increase in REPO rate on the lending interest rate and the share of non-performing loans in total bank credits, VAR model

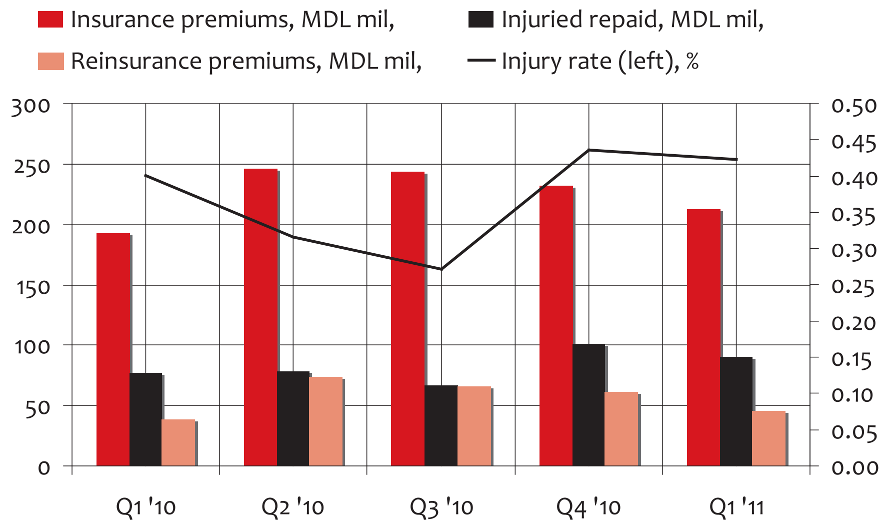


Source: Expert-Grup calculations;

Insurance sector: a modest, but steady recovery

The economic recovery was also mirrored in the insurance sector, but to a lesser degree. Thus, after the Q1'11, the total amount of collected insurance premiums increased by 10.1%, while the injuries repaid – by 16.3% y-o-y (Chart 30). As a result, the injury ratio increased to 42.3% (in May 2010 it was 40%). It augurs well for further consolidation of economic agents' confidence in insurance companies, which is the most important ingredient for the healthy development of this sector in the long run. At the same time, the amount of premiums received from reinsured risks increased by 16.8%. Given the fact that most of these risks are related to the insurance of buildings against natural calamities, such a visible rise can be explained by the tentative growth in the real estate sector and overall investment activity.

Chart 30. Main indicators of the insurance sector, 2010-2011



Source: NBM;

As in the previous year, the main driver of this sector is the mandatory (the responsibility of car drivers against the third party) and quasi-mandatory CASCO insurance (is required in case of leases and other forms of financing). After Q1'11 the share of these insurance products in total non-life insurance was 75%. Therefore, the insurance sector slow recovery was mostly explained by a modest growth on the car market, while the confidence issue persists.

Forecast

- The situation in the banking system will brighten further as economic recovery continues apace and investment outlook improves. The possible NBM attempts to tighten its monetary policy will have limited impact on lending, due to commercial banks' abundance in liquidities and relatively high bank margins;
- The lending interest rates are likely to remain at the current historical lows until the end of 2011. Unless new inflationary shocks occur and the price level reach the targeted interval, commercial banks could slightly decrease their lending interest rates due to narrowing risk premiums and lower inflation in 2012.

Policy recommendations

- The central bank should continue closely supervising the most problematic commercial banks in their attempts to clean up the balance sheets. Additionally, NBM should be vigilant enough to keep under control the current lending expansion and to prevent it from fueling inflationary pressures. Therefore, it should consider a gradual tightening of its monetary policy for a better anchoring of inflationary expectations;
- The policy makers should effectively address other structural issues to make commercial banks to remain skittish about lending, such as time consuming collateral execution and lack of extra-judicial approaches to solve these issues, poor judicial system and slow functioning of credit bureaus. Additionally, policy makers should be aware that the current unstable economic and, especially, political situation serves as another cause holding back the healthy development of the entire financial system.

14. Foreign Trade

On a brighter side…

The recovery of foreign trade not only continued but also became firmer in the first half of 2011 (Chart 31). In January-May 2011 both exports and imports surpassed historical heights of 2008. The rates of expansion are eye-popping: 63.2% and 47.3%, respectively. These rates are also impressive in global and regional comparison: global exports grew by 22.3% in Q1'11, and the EU and CIS exports increased by 18.6% and 28%, respectively[1].

The recovery of global and regional trade is undoubtedly one of the key drivers behind the expansion of Moldovan exports. Indeed, the data shows that exports increased more or less evenly along the geographical directions: the EU (+67.1%), the CIS (+61.2%) and 'third countries' (+52.9%). Furthermore, the exports growth in certain sectors, such as foodstuffs, fats and oils, footwear, is also mostly of recovery nature. However, there are certain relatively 'new' sectors where the expansion is fully-fledged, such as 'machinery and equipment'. In other words, exports' growth is continuously driven by recovery dynamics but also by some tentative structural changes epitomized by growth in non-traditional sectors.

From the destination standpoint the EU recaptured some of its share to hold 50.2% of total of Moldova's exports. Another 38.2% is held by the CIS markets, and the 'third markets' attained 11.6%. This dynamics points to return to pre-crisis trend of strong export growth to the EU and to the CIS, to lesser extent. The exports to the third markets are apparently in retreat as May data is fed into the picture. In the future annual data will provide more comprehensive basis for analysis.

On the import side the growth drivers are familiar. First, the rebounding remittances continue to fuel domestic demand reflected in most of the imports categories. Secondly, recovery of traditional and nascent productions leads to increases in imports of productive inputs. Thirdly, the rising fuel prices are boosting imports too.

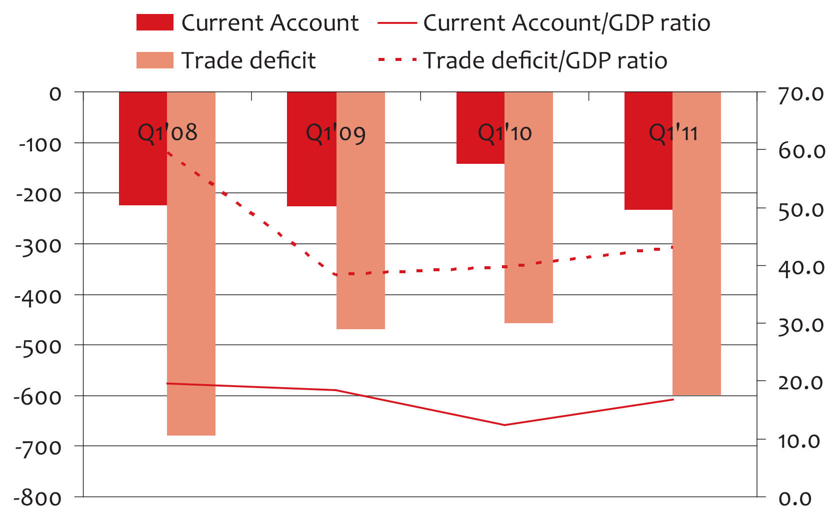
The faster expansion of the exports should not overshadow the fact that trade balance has plunged deeper in red. In January-April 2011 the deficit soared by 32.2% y-o-y to reach USD 865.9 million. Moreover, the ratio of the current account deficit to GDP grew again in Q1'11 y-o-y (Chart 31), showing underlying weaknesses in economic development: growth based on consumption, low level of domestic production and competitiveness. This trend reflects limited success and pains of transition to a new economic growth model for which Moldovan government has craved.

The situation in the service trade is somewhat better. Not only service trade continued recovering in Q1'11, but also the trade deficit contracted in annual comparison from USD 20.72 million to USD 18.01 million. These positive developments are chiefly driven by gains in exports in "Communications" and "IT" sectors. The expansion of exports of IT services is particularly spectacular and points at growth potential existing in this sector[2].

[1] WTO, short-term merchandise trade statistics, June 2011.

[2] See also "*Moldova after the Global Crisis: Promoting Competitiveness and Shared Growth*", World Bank, April 2011.

Chart 31. Quarterly evolution of the current account and trade (goods and services) deficit, y-o-y, absolute values million USD (left scale) and ratio of GDP, % (right scale)



Source: NBS, NBM, Expert-Grup calculations;

Forecast

- The expansion of foreign trade will continue although there are certain downside risks. The external environment will remain mildly favourable with weaker demand in developed countries. Most of all, the sluggish growth in the EU may affect adversely Moldova's exports. Further risks may stem from high energy prices which could undercut competitiveness of Moldovan companies. Ultimately, high food prices may appear a development that Moldovan agri-food exporter should capitalize on;
- The critical constraints to growth will represent key factors that may determine slowdown of exports expansion in H2'11. Poor infrastructure, high logistical costs, red-tape and underdeveloped human capital have not been tackled properly by current government and will undermine production expansion and long-term prospects for growth. With recovery potential almost exhausted the economy will need new engines for expansion via exports of goods and services. Overall, a more even growth in exports and imports may be expected in the H2'11, with annual growth rates for both exports and imports varying between 20-25% by the end of 2011;
- Sluggish growth in certain EU economies may affect adversely prospects of Moldovan labour migrants. Lower demand for labour may affect negatively remittances inflow and thus restrain the expansion of domestic demand. Nonetheless, given the counter-cyclical nature of remittances and low elasticity of labour demand in sectors of migrants' employment the remittances' recovery should be sufficiently robust to prop up domestic demand;
- However, the sluggish growth and tight labour markets of many EU economies may have undesired spillovers in the policy domain. It may harden negotiation position of the EU on the DCFTA and visa-liberalization as well as make immigration policies more restrictive posing risks to trade expansion. Conversely, the progress in the DCFTA process can foster important reforms and unlock growth potential in 'captured' sectors due to spillovers resulting from institutional reforms related to the DCFTA.

Policy recommendations

- The transition to the new growth model will require a policy shift in the Government's approach to development. At the heart of this policy should be dismantlement of the critical constraints to growth. Many of these constraints require sustained efforts in mid- and long-term, such as human capital development. Others such as cutting red-tape, reducing logistics costs, facilitating implementation of European standards and norms, and above all improving road infrastructure should be pursued with vigour in the nearest future;
- The ongoing shifts in centres of economic gravity have already led to some changes in Moldova's foreign trade. These changes are set to magnify in the future. The Moldovan government should take a pro-active approach and focus on promotion of Moldovan business interests and searching niches in outside the EU and the CIS. In this context, we reiterate the need for a coherent trade diplomacy and efficient horizontal/sector public-private agencies to promote exports and attract know-how;
- As European Commission was granted mandate to start negotiations on the DCFTA with Moldova, both government and companies are set for urgent dialogue and elaboration of positions on country's interests in various economic sectors. The urgency of the process stems not only from the importance of sectors per se, but also from magnitude of effects it will have on Moldovan enterprises, from resistance of certain vested interests and lack of competence on behalf of public bureaucracy.

15. Global Markets

A patchy global recovery

Global economy: a multi-tier growth...

The global economic growth has continued to show the already familiar trends: generally stagnant advanced world and buoyant emerging economies. On one hand, the US recovery appears much slower than expected with high unemployment and budget deficit. The economic outlook for the EU in its turn has been continuously plagued by the sovereign debt issue, while recovery remained tepid in most of parts of euro-zone. On other hand, emerging economies puffed ahead exposing signs of overheating. Furthermore, the shift in the centre of economic gravity has appeared to be associated with certain redistribution in geopolitical clout. China, in particular, has started playing an increasing role for some time (see for instance negotiations as part of G20, Copenhagen and Cancun conferences on climate change, Doha round of the WTO negotiations, etc.) and appears to be ready to step in the settlement of the sovereign debt crisis in the euro-zone (both as buyer of debt and as participant in eventual privatization). So while the world economy expanded by 4.3%, y-o-y, in the Q1'11 (Table 3), this healthy growth should not hide growing discrepancies between stagnant and debt-laden most of advanced world and dynamic but excessively dependent on external demand emerging world. In this sense, the way, ordered or disordered, the unwinding of these imbalances proceeds will affect enormously the future of global economic growth.

Table 3. Selected World Economic Outlook projections, year-on-year % change

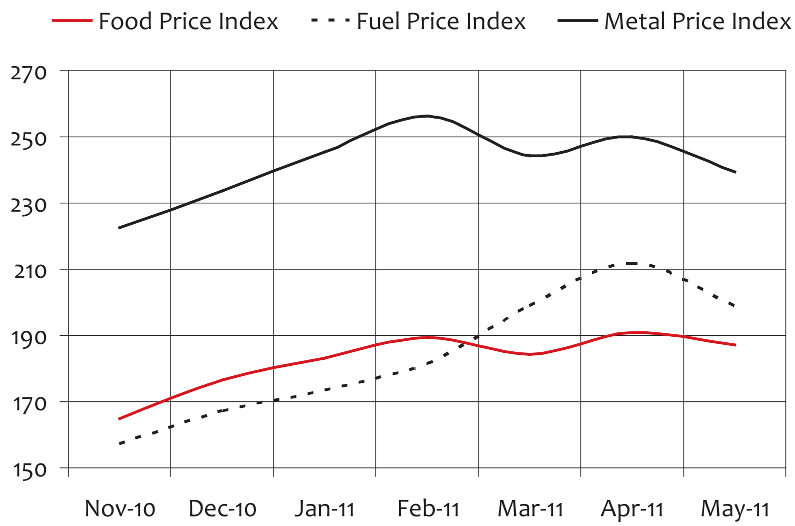
Economic grouping / Geographic area	2010	2011	2012
World output	5.1	4.3	4.5
Advanced Economies	3.0	2.2	2.6
United States	2.9	2.5	2.7
Euro area	1.8	2.0	1.7
Germany	3.5	3.2	2.0
Italy	1.3	1.0	1.3
Emerging and developing economies	7.4	6.6	6.4
Central and Eastern Europe	4.5	5.3	3.2
Romania	-1.3	1.5	4.4
Poland	3.8	3.8	3.6
CIS	4.6	5.1	4.7
Russia	4.0	4.8	4.5
Ukraine	4.2	4.5	4.9
Developing Asia	9.6	8.4	8.4

Source: WEO Update, June 2011, IMF;

Commodity markets: a volatile recovery

The situation on the commodity markets remained highly volatile (Chart 32). The Q1'11 featured rising prices almost across the whole board of commodities. In particular, oil prices at one moment reached 125 USD per barrel (Brent) mark sending markets and consumers in jitters. The rise in commodity prices generally receded since then. The overall upward volatility in oil prices is determined by strong demand in emerging economies, weak dollar and geopolitical instability. In its turn, high oil prices fuelled high level of food prices. The food prices are also affected by both fundamental trends (rising demand and higher calorie diets as people get richer, diversion of land from food to energy goals, stagnant investment in agricultural research as well as falling water tables in certain countries) and speculative ones (food is also increasingly seen as investment). The trends have already had daunting impacts over Moldova, as rising fuel prices have hit both companies and consumers. At the same time, although Moldovan consumers feel the rise of food prices, it appears that Moldovan farmers have not been able to capitalize on this trend properly.

Chart 32. Evolution of main commodity indexes, November 2010 — May 2011.



Description: *Commodity Metals Price Index includes Copper, Aluminium, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices; Commodity Fuel (energy) Index includes Crude oil (petroleum), Natural Gas, and Coal Price Indices; Commodity Food Price Index includes Cereals, Vegetable Oils, Meat, Seafood, Sugar, Bananas, and Oranges Price Indices; 2005 = 100;*
Source: IMF;

Forecast

- The underlying global economic risks can significantly dent Moldova's economic growth prospects and macroeconomic stability. Further in 2011 the recovery in most of advanced economies will remain sluggish, however, in mid-term the risks to global growth may magnify. Some of the pundits[1], give high probability to a disastrous 'perfect storm' happening somewhere in 2013. Fiscal woes in the US, economic slowdown in China, debt restructuring in Europe and stagnation in Japan may converge in order to give nascence to this storm. Aside from this apocalyptic scenario, the generally anaemic growth is a probability as well. The latter points again in direction of further consolidation of trade links with the main emerging economies, in the case of Moldova China and Turkey most of all;

[1] See *"Roubini says 'Perfect Storm' May Threaten Global Economy"*, Bloomberg June 13, 2011, http://www.bloomberg.com/news/2011-06-11/china-economy-at-risk-of-hard-landing-after-2013-nouriel-roubini-says.html.

- If global economic growth moves along current patterns, the prices for main commodities will remain high and volatile. The strong demand from the emerging economies will prop up higher oil prices, while political instability in the Middle East will surely persist if not heighten from now on. This, together with continuous volatility on FOREX, will at least uphold commodity prices on the current levels.

Policy recommendations

- One of the key policy challenges will be to maintain Moldova's "European dream" alive while making amends and seeking to capitalize on dynamic developments in the markets outside Europe. Indeed, embarking on the institutional reforms associated with the European integration process will be extremely important. However, the ongoing euro-crisis and well as eventual 'reshaping' of the EU could eventually harm either Moldova's prospects or thirst for this endeavour. The Government should be forward-looking and not using "European integration" as universal cure in domestic politics nor should it create exuberant expectations in this regard;
- As global imbalances remain very much unresolved and majority of developed countries face significant budget constraints, the economic centre of gravity will continue moving towards emerging markets. Want it or not, this effect will ultimately weigh on Moldovan policy-making. In longer-term the success of emerging economies might prompt re-thinking of economic policy in Moldova, including the role the state can or should play in economic development;
- The high and volatile commodity prices should spur reforms aimed at competitiveness of various sectors of Moldovan economy. More specifically, emphasis should be put on energy efficiency (yet again) both on company and household levels as well as unlocking productivity gains in the agrifood industry. As rising fuel and food prices hit severely companies and households alike, transparency and reliability of tariff calculation should be ensured, social nets improved, competition rules enforced and vested interests purged.

About the Expert-Grup

Who we are

EXPERT-GRUP is a leading economic think-tank in Republic of Moldova. It is member of the PASOS (Policy Association for an Open Society) network comprising 39 policy think-tanks in 27 countries from Central and Eastern Europe and Central Asia.

Our mission

The institutional mission of the Expert-Grup is to contribute to the economic, democratic and social development of Republic of Moldova, as well as to promote its international competitiveness. We tend to accomplish this mission by delivering top quality services and promoting efficient, transparent and innovative policy models.

Main activities

- Provide the public with relevant and most up-to-date analysis on economic trends;
- Offer assistance and consultancy in the decision-making and policy-making processes;
- Promote innovative development solutions and policy models.

Areas of expertise

- Development strategies;
- Macroeconomics and economic systems;
- Global economy and international economic relations;
- Economy of the European integration;
- Monetary and fiscal policies;
- Labour economy, management and business culture;
- Consumer behaviour;
- Industrial and agricultural economics;
- Economy of health and education.

Contact details

- address: MD-2012, Columna str., 133, Chisinau, Republic of Moldova;
- telephone: +37322-93-00-14, +37322-21-15-99, fax +37322-21-15-99;
- e-mail: info@expert-grup.org;
- web: www.expert-grup.org.